

# OVERVIEW OF THE ESTATE PLANNING FOR SMALL BUSINESS OWNERS<sup>1</sup>

by Robert K. Kelley

The form of business ownership that an individual chooses will substantially affect the options available in planning his estate. Nevertheless, when evaluating and planning for business persons, especially those involved in closely held businesses, some, if not all, of the following problems should be addressed:

- Providing for successor management of the business enterprise in the event of the owner's death, disability or retirement. If successor management cannot be found within the family, an outside search must be conducted or internal potential must be developed. In either case, incentive compensation programs should be prepared with this eventuality in mind.
- Building a second estate which will provide the cushion if the unexpected occurs and the business fails. Whether the business is successful or whether there is a plan for successor management, it is generally unwise for the business owner to have all his assets invested in the business.
- Providing a reserve fund as additional capital for the use of the business upon the death, disability or retirement of the owner. Often the real value of the business is attributable to the present owner — his talents, his knowledge, his contacts. Such a reserve fund may be justified if one considers the possible loss of key customers, increased difficulty in obtaining credit and financing, and the need for extra working capital to allow for successor management and experience.
- Determining the market potential in the event a sale of the business to outsiders or insiders is required or desired. Buy-sell agreements between associates should be considered along with any other provisions which may enhance marketability.
- Evaluating the effect of transfer taxes and options available to reduce or cushion the impact of the estate taxes, such as an established pattern of

lifetime gifts to friends and family, charitable giving, and methods of fixing or "freezing" values of assets.

- Determining and planning for potential liquidity needs of the estate of a deceased business owner to pay debts and funeral expenses, administration expenses, federal and state death taxes and cash bequests. The business may qualify for an extension of time within which to pay estate taxes under Internal Revenue Code (IRC) §6166.

- Valuing the business interests for gift tax, sale or estate tax purposes. If, for example, a farm or business real estate is involved, eligibility for special use valuation under IRC §2032A should be considered.

Tax considerations, particularly the changes affected by the Economic Recovery Tax Act of 1981 (ERTA) and the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), will necessarily play an important role in the planning process. The remainder of this article will focus on the three primary forms of business ownership and highlight the planning which is appropriate in each case in view of current tax laws.

## Sole Proprietorship

Although perhaps the most common form of business ownership, the sole proprietorship affords few, if any, estate planning opportunities. Except in the rare situation where a ready, able and willing buyer is waiting in the wings or a legatee is willing and able to continue the business, the ultimate disposition is liquidation of the business.

Assuming that the owner does not desire to incorporate or form a family partnership, there are still several vehicles available to provide tax shelter and some measure of estate planning benefits:

- Use of a Keogh plan, under which the owner

1. Presented at the annual conference of the International Society of Arboriculture in Indianapolis, Indiana in August 1983.

may set aside \$15,000 or 15% of his income, whichever is less, provided all full-time employees with at least three years of experience are included in the plan.

- Use of an Individual Retirement Account (IRA) either to supplement a Keogh plan or substitute in its place if the owner does not wish to include employees. The limits on the IRA are \$2,000 for the owner, plus an equal amount for his spouse, if also employed, or a total of \$2,250 if the spouse is not employed.

- Use of a Simplified Employee Pension (SEP) plan under IRC §408(k). Although administration is relatively simple, all employees over 25 must be included in the plan.

- Careful selection of an executor who has sufficient knowledge of the business or sophistication in general business matters to properly conduct the business, in accordance with the deceased owner's desires, until sale.

- Special use valuation under IRC §2032A, which may be available where the adjusted value of the property used in farming or another trade and business equals 50% or more of the adjusted value of the gross estate, and the adjusted value of the qualified real estate equals 25% or more of the adjusted value of the gross estate. Although "material participation" is still required, ERTA has relaxed the rules for qualified use and has shortened the period for continued use by the years from 15 to 10 years.

- If the value of a closely held business exceeds 35% of the decedent's adjusted gross estate, the estate may, in some circumstances, have up to fourteen years within which to pay that portion of the federal estate tax attributable to the business, in accordance with IRC §6166.

### Partnership

The partnership form of business is subject to many of the estate planning limitations of a sole proprietorship. It does, however, boast the advantage of having at least one other person involved in the business who can purchase the business interest upon the death of the partner. Normally, death of one of the partners automatically terminates the partnership unless the partnership agreement provides otherwise. The resulting distribution of partnership assets to the partners

or their successors in interest can often result in disastrous losses to all. There are, however, four alternatives available, each involving varying tax consequences: 1) a sale of the deceased partner's interest to the remaining partners, 2) a sale of the interest to one or more new partners, 3) a distribution to the deceased partner's estate, or other beneficiary, and liquidation of the interest, or 4) continuation as a partner by the estate or other designated beneficiary.

The determination of the value of a partnership interest for either a buy-sell or buy-out agreement is a matter properly negotiated by the partners. Once determined, however, if the price is binding on all parties and they are not free to dispose of their interest during life, the price set in the agreement is generally accepted as the basis for estate tax valuation. If there is no agreement, the fair market value as of the date of death or alternate valuation date must be determined, a task which can often prove very difficult.

The special use valuation provision of IRC §2032A, as well as the estate tax deferral benefits of IRC §6166 are also available provided the deceased partner owned at least 20% of the capital interest in the partnership or there were not more than 15 partners. In addition, the tax sheltered retirement benefits available to partners are the same as those available to a sole proprietorship — Keoghs, IRAs and SEPs.

### Corporation

By far, the corporate form of business provides maximum flexibility for estate planning. But it is not always necessary or appropriate to put the whole enterprise into a single corporation. The possibility of combining the corporate form with individual or partnership ownership should not be overlooked. The use of multiple corporations should also be considered.

Although there are advantages to preorganizational planning, there are still many things that can be done at the postorganizational stage to achieve worthwhile financial and estate planning benefits. The owner of a successful operating company often sees his business increasing in value to the point where continued appreciation will either expose his estate or, if the owner makes use of the unlimited marital deduction, the estate of the sur-

living spouse, to federal estate tax at high rates. To avoid this, the owner may consider freezing the value of his interest at its present level and making gifts of the potentially appreciable interest to junior members of the family at relatively low gift tax cost.

The primary method by which this objective may be accomplished is by recapitalization, the typical scenario involving the senior family member exchanging his common stock for common and preferred stock in a tax free exchange in accordance with IRC §368(a)(1)(E). The preferred stock will carry the present fair market value of the business and the common stock will carry the appreciation potential. At the owner's death, the preferred stock will then be included in the gross estate at par value.

However, care must be taken to insure that the capitalization has a bona fide business purpose; the mere saving of taxes is not such a bona fide business purpose according Rev. Rul. 77-321. The principal problem with recapitalization is that a lifetime disposition of the preferred stock may result in ordinary income under IRC §306. Still, if the stock is merely preferred with respect to a fixed dividend and repayment of par value on liquidation, and both the common and preferred stock have equal voting rights and are otherwise entitled to share equally in dividend and liquidation proceedings, it may not suffer the IRC §306 taint.

A holding company may also be a vehicle for effecting a freeze. In its most basic form, senior family members exchange their common stock in the operating company for preferred stock and new common stock in the holding company and then give the common stock to junior family members.

The use of an Employee Stock Ownership Plan (ESOP) is another means of furthering the interest of the principal shareholder of a corporate enterprise, especially in view of the improved leverage and other advantages afforded by ERTA. In particular, an ESOP can be very useful in connection with the disposition of an interest in a closely held corporation. In particular, it may be used to buy out the interest of the deceased shareholder. A sale of stock by an estate to an ESOP provides the same liquidity as an IRC §303 redemption to pay death taxes, funeral and administration ex-

penses, and yet avoids the limitations of a §303 redemption.

The private annuity offers still another method of planning for business interest, particularly with respect to closely held corporations. Typically, under the private annuity arrangement, the parent stockholder sells his stock in the corporation to his children in return for their promise to pay him, and often his spouse, a fixed sum annually or at shorter intervals for life. The principal advantage of the private annuity is that it offers, if properly structured, the ability not only to freeze the value of the transferred stock, but also to remove an asset from the transferor-annuitant's estate without incurring either gift or estate tax. Theoretically, the value of the transferred stock will equal the value of the annuity contract: hence, no gift tax. And, on the death of the transferor-annuitant, the annuity obligation typically ends: hence, no estate tax.

Installment sales, and the favorable tax consequences which a sale structured in this manner may receive, provide yet another method by which one can freeze the value of the business interest. This is accomplished by converting the value of the asset into a fixed maturity debt obligation. As long as the value of the promissory note equals the value of the corporate stock transferred, there will be a transfer for full and adequate consideration and no gift will result. The value of the note as of the date of the noteholder's death will, however, be an asset includible in the decedent's gross estate. But under the Installment Sales Revision Act of 1980, the noteholder will have reported the gain from the sale of the property in proportion to the receipts in each year.

Finally, use of a family investment company can provide significant financial estate planning advantages. Properly structured, it can, among other things, shift income from a high bracket family member to those in lower tax brackets, provide an alternative to recapitalization of one or more closely held corporations, effect gift tax savings on a transfer of the interest to junior members, and effect estate and gift tax savings on transfers at death. However, to obtain many of the available benefits, the investment company must not qualify for treatment as a personal holding company. As a practical matter, this means that personal holding

company income, as that term is defined by the Internal Revenue Code, must be distributed annually or risk imposition of a penalty tax. Thus, shareholders face double taxation of earnings, once at the corporate level and again at the individual level when earnings are distributed to them. But as a result of the Subchapter S Revision Act of 1982, it may be possible to escape double taxation through a Subchapter Selection.

#### Conclusion

Regardless of what form of business entity is most desirable from an estate planning point of

view, the desires of the client, although often frustrating optimal use of the techniques available, must take precedence. Where possible, the corporate form generally offers the greatest opportunity for estate conservation and tax savings. However, all forms of business ownership offer some opportunity for estate planning, if properly utilized.

Attorney,  
Silver & Kelley  
Denver, Colorado

---

## ABSTRACTS

NORRIS, C.A. 1983. **Native plants in the landscape blend regional distinctiveness with low maintenance.** *Am. Nurseryman* 157(6): 98-102, 106-112, 114, 116, 118-120, 122.

With the increasingly fast pace of life in America, more and more homeowners are demanding low-maintenance landscapes. Companies want less energy-intensive grounds for their office buildings. Landscaping with native plants can satisfy both of these requirements. Not only do they need less maintenance than introduced, exotic species, but they also express the distinctiveness of the local area. Once non-natives were considered rare; now they are common in landscapes. The opposite is true of native plants in the landscape, which now seem exotic because of their lack of use in recent history. Some introduced species blend well with native species in the landscape and should be considered. But overusing certain introduced species has resulted in a sameness in traditional landscapes across broad regions of the U.S. And these landscapes are increasingly expensive to maintain.

GOUGH, PAUL. 1983. ***Bacillus thuringiensis* applied by air works against gypsy moth.** *Frontiers of Plant Science* 35(1): 2-3.

The gypsy moth has periodically caused widespread defoliation and many landowners turned to insecticides for relief. Although ground spraying provides control, aerial application costs less per acre, uses less insecticide, and is the only practical means of treating large acreages. State regulations prohibit aerial application of chemical insecticides on residential and forest land, so only biological materials, such as the bacterial insecticide, *B. thuringiensis* (*Bt*), may be used. New strains and improved formulations more toxic to gypsy moth caterpillars have recently been developed. Therefore, the Experiment Station, the U.S. Forest Service, and the State Department of Environmental Protection cooperated in two years of testing of three new strains and formulations of *Bt* for gypsy moth control. In these experiments, one application of an increased dose of 1.5 qts/acre was virtually as effective as two treatments at the standard rate of 1 qt/acre per treatment. Therefore, equal protection was obtained at the cost of one application.