

Special Edition

Successor Planning Part 9

Last week, I discussed easing out of the business and structuring buy/sell agreements. As I stated, executing a buy/sell agreement requires careful planning. You need to engage an attorney competent in section 2703 of the Internal Revenue code. I also reviewed the 5 tests that must be met for a buy/sell agreement price to be accepted by the IRS.

When developing an exit strategy, there are all types of options you need to consider from a tax standpoint. In some cases, private annuities are used as a business succession tool. This is where a member of the senior generation transfers assets to a family member in exchange for a life time income.

Private annuities are similar to insurance annuities, but they're different in the way they are funded. Instead of an insurance company providing the vehicle, the private annuity is agreement between two entities or individuals and is not involved in an insurance company. This strategy is not used all that often, but it can be a viable option for close families who own an interest in a small trucking company and whose owner is nearing or past retirement age.

For example; assume a husband and wife own a trucking company and they want to pass it down to their children;

- A certain amount of money can be paid to the parents, at the time that the transfer begins.
- The private annuity will provide a lifetime income for the retiring founders.

With a private annuity, the owner, or parent, transfers assets to a successor or child. In return, the successor agrees to pay the owner a fixed amount each year for the rest of the owner's life. When the owner dies, the transaction is completed, the annuity payment ceases and the successor owns the assets.

Assuming the transferred assets are properly valued, no gift tax will be due. The annuity payments will be partially sheltered. Then, at the owner's death, no estate tax will be due.

A private annuity can provide tax sheltered income, while reducing gift and estate taxes. The value of the business will not be included in the gross estate tax purposes, provided the value of the annuity equals that of the exchange business interest. If the founder dies early, the appreciation in his/her business, after the transfer, escapes tax. If he/she lives longer than their life expectancy, the annuity payments will exceed the value of the business.

This structure can become very complicated, so I'll try to provide a simple example. Suppose you're age 65 and the sole owner of a business worth \$800,000;

- You transfer the assets to your children, in return for a life time annuity of perhaps \$90,000 a year.
- Your children now own the business assets.
- You owe no gift tax.

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July 31, 2009

- Your heirs won't owe gift tax after your death.

To earn such benefits, however, you must adhere to the rules:

1. **You need a credible evaluation**, preferably by a reputable third party. Remember; the IRS will recast the transaction as a taxable gift if the value is "low balled".
2. **You need a fair annuity obligation**. If you have a 20 year life expectancy and the IRS imputes a 10% interest rate, you might have to receive more than \$110,000 per year for business valued at \$800,000. Those payments must continue for the rest of the founder's life, even if he/she lives another 30 years.

Note, the IRS will not recognize a private annuity when the owner has a terminal illness.

One drawback of a private annuity is that the seller retains no secured interest in the business. If the seller wants to retain security interest in the business, an option is to take back a self-cancelling installment note, or SCIN; this is known as a security interest note and the SCIN is, basically, a promise to make payments, periodically, until the death of a seller or some other individual, or until a maximum sales price is received. **Like the private annuity, the "SCIN" will have to leave no asset on the seller's estate.**

The danger is that if any remaining payments, on the note will be forgiven at the founder's death, then any gains from the forgiveness of death would be taxed in the founder's estate. In essence, for a close family, the private annuity is an unsecured promise to keep making annual payments. **The question becomes; if you're going to do this with your children;**

- **Do you believe** that your children, under any circumstances, regardless of the financial condition of your company, will keep their obligations?
- **Do you believe**, if you give the business to your children, with no risk involved, they will continue to perpetuate the business to the next generation?
- **Do you feel comfortable** that your retirement account is in the hands of your children?

These are all very difficult questions to answer. If you review the horror stories that have been transpired with some family business, it is a risky venture. However, if you have decided that this is the way in which you want to transfer the business, then you need to make sure that the second generation has some risk and exposure;

- **You can possibly take a lien** on their retirement accounts. (if you can legally do that).
- **You may take a lien** on their house.

Again, by utilizing a competent attorney that specializes in, not only estate tax issues, but transportation; there are ways to protect and safe guard your retirement.

Next week, I will be focusing on various types of trust documents, and tax free organization and employee stock ownership plans.

QUOTE OF THE WEEK:

"Integrity will affect your destiny; don't leave home without it".