LATHROP GPM LLP

OWNERSHIP TRANSITION PLANNING

JUNE 11, 2020

I. TRANSFERRNG YOUR BUSINESS TO FAMILY OR OTHER "INSIDERS": OVERVIEW

A. Buy-Sell Agreement

B. Gift

C. Installment Sale

D. Grantor Retained Annuity Trust (GRAT)

E. Sale to Intentionally Defective Grantor Trust (IDGT)

II. BUY-SELL AGREEMENTS

A. What is it: "A contract between the owners, or between the owners and the business, to provide for the transfer of all or part of an owner's interest upon certain events for a predetermined price and term."

B. Why is it Important: Only way to bind other owners

C. How does it Work:

1. General rule – prohibits all transfers

2. Exceptions – consent or waiver; exceptions to exception; permitted transferees

3. Applies on "trigger" events –

death

disability

termination of employment

attempted gift or sale

bankruptcy/divorce/involuntary transfer

4. Specifies who buys, what order, mandatory or optional

D. Types of Agreements:

1. Redemption -

    business itself buys

    increases ownership percentage of other owners

    can be mandatory or optional

2. Cross-purchase –

    other owners buy

    C corporation owners receive step up in basis

    funding with life insurance can be problematic

    can be mandatory or optional

3. Hybrid –

    combination of above

    flexible, series of options ("wait and see")

    eg. 1st option to active successor

    2nd option to other owners

    3rd option to business

    or

    1st option to company

    2nd option to other owners; etc.

E. Typical Provisions:

1. Sets price –

    agreed value at transaction

    stipulated value set regularly

    appraised value (Fair Market Value "FMV")

2. Sets terms –

    downpayment

installment term

interest rate

use of insurance proceeds

F. What to do Now:

1. If multiple owners and no agreement – GET ONE!

2. If agreement exists – DUST IT OFF!

   Consider: price, terms, funding, structure

III. GIFT

Common to family; rare to other insiders

A. How does it Work:

1. Decide how much you can afford to give –

   loss of income

   fairness to other children

2. Structure ownership to maximize discounts

3. Transfer ownership –

   stock certificates, assignment of LLC or partnership interest

   follow rules of Buy-Sell (permitted; consents)

4. Get a good appraisal –

   use lower range of reasonable Fair Market Value at date of gift

   direct appraiser to consider discounts (lack of control, lack of marketability)

5. File gift tax return –

   annual exclusion ($15,000/person/year)

   lifetime federal gift tax exclusion ($11.58 million/person)

B. Advantages:

1. Simple

2. Relatively inexpensive (legal, appraisal, accounting)

3. Gets business, or gifted portion, to active successor now

4. Gets you “out” (no strings on gift)

C. Disadvantages:

1. Loss of gifted asset and related income

2. Difficult to equalize to other children

3. Loss of potential step up in tax basis

4. Not maximum leveraged use of gift tax exclusion

D. Effect on Control:

1. Depends on percentage given

2. May depend on relationship with spouse – joint “effective” control

3. Depends on gift of voting versus nonvoting equity

E. Why Now: Depressed values make it easier to transfer more business for less; “Supercharge” the gift

1. Less use of gift tax exclusion

2. Less inequity to other children

IV. INSTALLMENT SALE

Common to family, other owners, and key employee(s)

A. What is it: “Any disposition of property where at least one payment is to be received after the close of the taxable year in which the disposition occurs.”

1. Buyer defers payment

2. Seller defers gain

B. How does it Work:

1. Seller transfers property to Buyer for a Note

2. Buyer pays principal plus interest over time

3. To avoid “bargain sale” and deemed gift, sale at Fair Market Value (FMV) supported by appraisal

4. To avoid imputed interest income to Seller, interest = AFR

C. Advantages:

1. Facilitates transfer (Buyer can afford to buy over time)

2. Buyer gets immediate ownership and tax basis

3. Provides income stream to Seller and diversifies portfolio

4. Freezes asset value in Seller’s estate; Buyer gets appreciation

5. “Fairier” to other insiders (Buyer has to pay)

6. Seller recognizes only a percentage of payment as income each year –

$$\% = \frac{\text{gross profit}}{\text{contract price}}$$ (i.e. FMV of sale over S basis)

D. Disadvantages:

1. Buyer has to pay (versus gift); should be FMV

2. Seller has to recognize some gain –

lower the basis is to sale price, higher % of each payment is gain

3. May tie up assets in non-diversified note

4. Does not remove value of asset from Seller’s estate (cash and note substitute for business)

5. Risk of unintended gift or imputed income if price, rate too low

6. Risk of getting business back on Buyer’s default

– if payments secured by pledge of business

E. Effect on Control:

1. Depends on percentage sold

2. May depend on relationship with spouse – joint “effective” control

3. Depends on sale of voting versus nonvoting equity

F. Why Now: depressed values and rates facilitate ("Supercharge") the sale

1. Lower values mean lower FMV sales price

2. Lower rates mean lower payments

June 2020 Applicable Federal Rates (AFR)

Short-Term	≤ 3 years	.18 annually	
Mid-Term	> 3 ≤ 9 years	.43 annually	DON'T WAIT!
Long-Term	> 9 years	1.01 annually	

V. GRANTOR RETAINED ANNUITY TRUST ("GRAT")

Common to family; rare to other insiders

A. What is it: An irrevocable (can't be changed) trust to which you (the "grantor") transfer assets in exchange for an annuity

B. How does it Work:

1. Create the irrevocable trust for your successor

2. Transfer your business interest to the trustee

3. File a gift tax return reporting the gift and use portion of $11.58 million lifetime gift exclusion

4. Trustee pays you the retained annuity for the term

5. At end of term, business interest passes to successor – outright or in further trust

C. Advantages:

1. Leveraged way to gift the business –

    retained annuity decreases value of gift

    appropriate discounts reduce value of transfer

2. After trust term, transferred business interest is totally removed from your estate

3. Any appreciation over IRS assumed rate passes to successor gift tax free

4. Provides you “safety net” of some retained income through the annuity

5. During the term as you continue to pay all income taxes on the transferred asset, you make a tax free gift to your successor

6. GRAT is “blessed” by statute and IRS regulations

D. Disadvantages:

1. If you do not survive the term, portion of the transferred property comes back into estate – “lost” the best and are out transaction costs

2. During the term, you continue paying tax on income you don’t get

3. If assets do not perform as expected, get portion of it back – “leaky” GRAT

4. Should not be used for generation-skipping (transfers to grandchildren)

E. Effect on Control:

1. Depends (again) on percentage transferred, spouse’s ownership, and nature of equity transferred (voting; nonvoting)

2. Remember that during trust term, trustee controls that interest; after term, active successor controls; not you

F. Why Now: Depressed values and rates “Supercharge” the transfer

1. Lower values mean smaller gift (less gift tax exclusion; fairer to other children)

2. Lower rates make it easier to “beat” the IRS hurdle

   IRS assumed return = Section 7520 rate – 120% mid term AFR

   June 2020 §7520 rate = .6%

3. This means if your business can earn > .6% return annually, a GRAT will allow you to gift that excess return to your successor gift tax free

VI. SALE TO AN INTENTIONALLY DEFECTIVE GRANTOR TRUST (“IDGT”)

Common to family, sometimes to key employee, rarely to other owners

A. What is it: An irrevocable trust to which you sell assets in exchange for a promissory note. The trust is designed to remove the asset from your estate, but intentionally to fail to remove the asset from your income tax return (hence, the name “defective”).

B. How does it Work:

1. Create the irrevocable trust for your successor
2. Transfer "seed" money by gift to trust – usually > 10% of planned sale value
3. Sell business interest to the trustee at FMV – value supported by appropriate appraisal with discounts
4. File a gift tax return for initial transfer and sale
5. Trustee pays you on note during note term
6. At end of note term, business interest in trust passes to successor – outright or in further trust

C. Advantages:

1. Transfers business using less gift tax exclusion – only the "seed" money is a gift
2. "Freezes" the value in your estate because the note with a fixed value, not the business, is included
3. Further decreases your estate as you continue to pay all income tax (ordinary and capital gain) on transferred interest
4. Trust assets grow income tax free for benefit of beneficiaries
5. Provides asset protection for business from your creditors and beneficiary(ies) creditors
6. "Hurdle" rate on the note is lower than GRAT rate (AFR versus §7520)
7. Trust can benefit grandchildren and further descendants

D. Disadvantages:

1. Need adequate liquidity for the "seed" gift
2. You continue to pay income tax on income you don't get – includes tax on a future sale of the business transferred; continues past note term, for life, unless you "turn off" grantor status
3. If you die before note is fully paid, could be income tax consequences
4. Not "blessed" by statute like GRAT; technique threads discrepancy between estate tax and income tax rules; no IRS guidance

E. Effect on Control:

   1. Depends (again) on facts

   2. Remember that you no longer control the transferred interest; trustee does unless/until interest is distributed

F. Why Now: Depressed values and rates “Supercharge” the transfer

   1. Lower rates mean smaller gift of “seed” money

   2. Lower rates mean lower FMV sales price

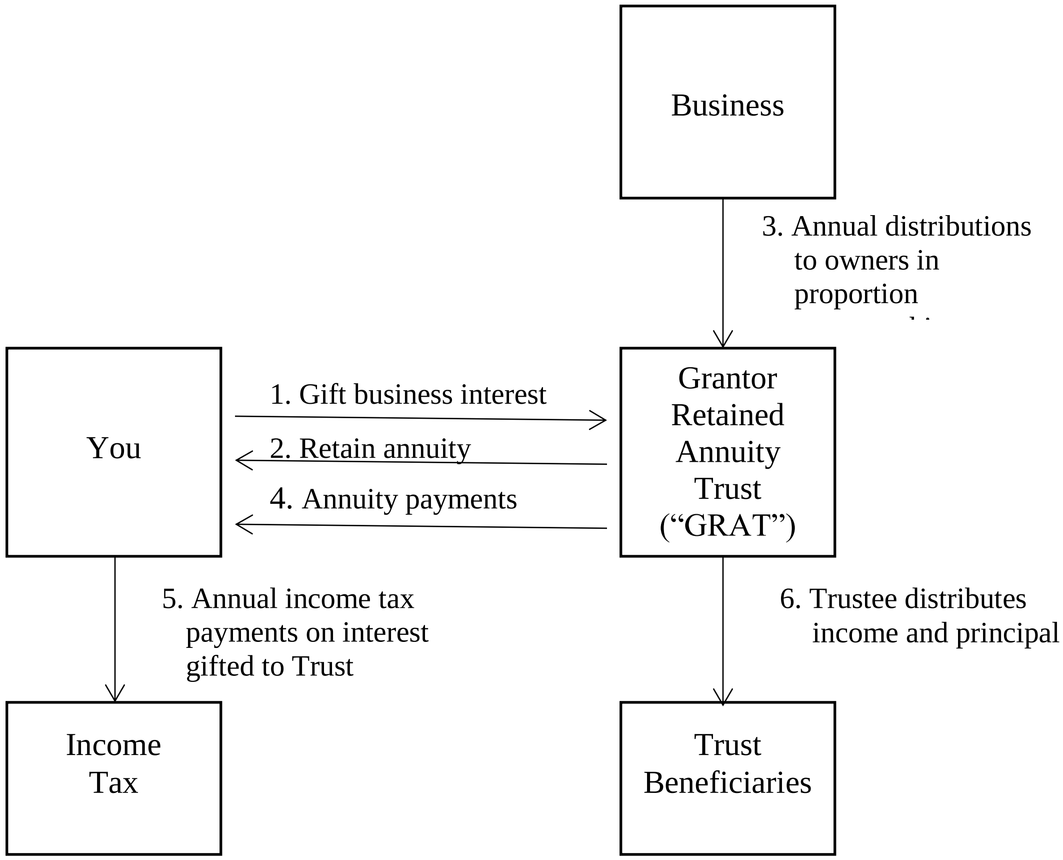
   3. Lower rates mean lower payments

June 2020 AFR vs. Section 7520

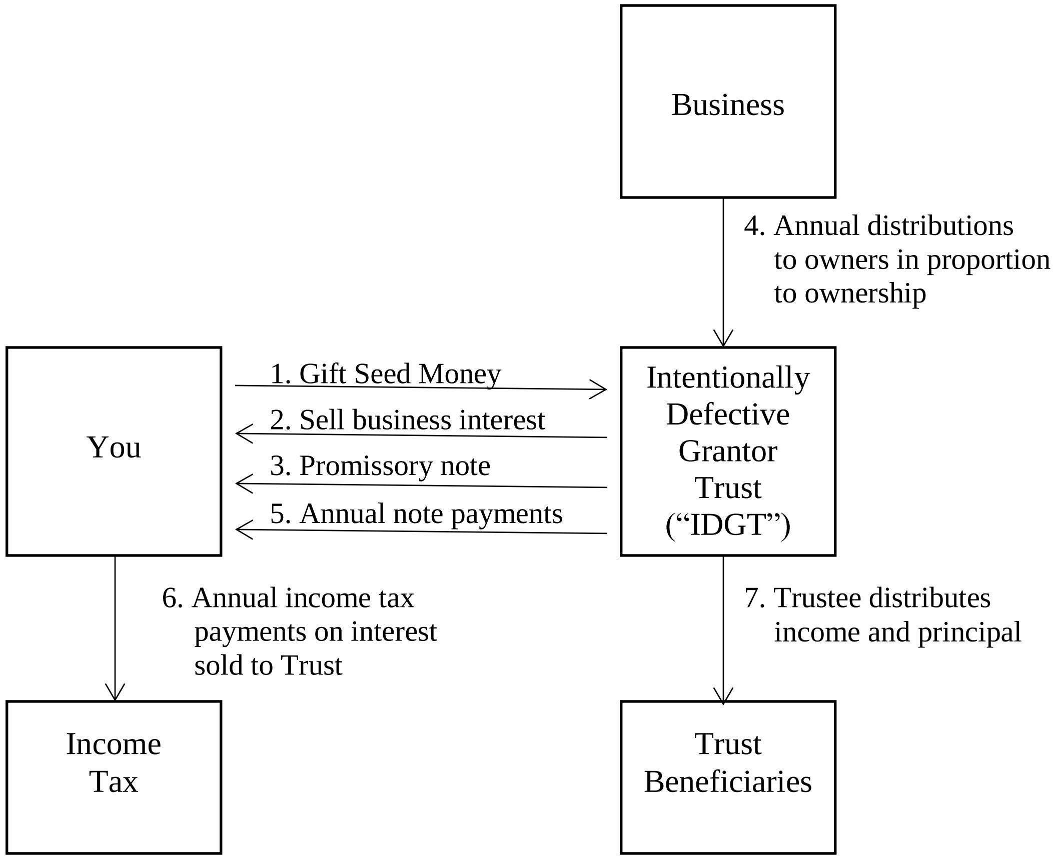
Short-Term	.18	< .6%
Mid-Term	.43	

   4. This means if your business can earn > .18% return, on a 3 year note, or > .43%, on a 3 to 9 year note, a sale to an IDGT will allow you to pass excess return to your successor gift tax free

Gift to GRAT


Business
3. Annual distributions to owners in proportion
You
1. Gift business interest
2. Retain annuity
4. Annuity payments
Grantor Retained Annuity Trust ("GRAT")
5. Annual income tax payments on interest gifted to Trust
6. Trustee distributes income and principal
Income Tax
Trust Beneficiaries

Sale to IDGT


Business
4. Annual distributions to owners in proportion to ownership
You
1. Gift Seed Money
2. Sell business interest
3. Promissory note
5. Annual note payments
Intentionally Defective Grantor Trust ("IDGT")
6. Annual income tax payments on interest sold to Trust
7. Trustee distributes income and principal
Income Tax
Trust Beneficiaries