PLANNING AND DRAFTING STRATEGIES FOR FAMILY BUSINESS OWNERS (WITH FORMS)

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One of the most difficult challenges facing those who advise owners of family businesses is to get them to take the first step in the planning process. Too many advisors present many alternative (and sometimes conflicting) strategies, leading the business owner to conclude that this planning is an all-or-nothing thing.

I recommend, in the alternative, that you make the first step as small as possible, just to get the family business owner started on the path to business succession planning.

Do not let the client think that everything must be done at once. Try to avoid complicated design schematics, which are meant to diagram the entire end result on one piece of paper. I had one client tell me later that the paper looked like "the wiring diagram for a nuclear submarine." Why make the first step so big?

Start with the low hanging fruit, such as a simple update to the client's estate planning documents and medical directives. After the owner begins the process, I have found it is easier to keep them going.

While the focus of this article will be on the drafting of the actual estate planning documents, care must be taken not to lose sight of the fact that the lawyer is merely writing down the decisions made by the client. The planning process itself is insurmountably linked to the drafting process.

Therefore, some of what follows is arguably in both the planning and drafting categories, as one cannot be separated from the other.

Let me divide this material into a number of issues which the planner must consider, presented not necessarily in the order of their importance.

CASH FLOW FOR THE SURVIVING SPOUSE

This is one of the most critical issues which must be addressed as part of the family estate and business succession plan. If the owner has been taking cash flow out of the business in the form of compensation, how will the surviving spouse get cash when her husband dies and his compensation stops? (For ease of reference, this outline will assume that the family business is owned by a man; the pronoun should be read to be interchangeable as more and more family businesses are started by and owned by women.)

The business owner who believes the business will continue its earnings uninterrupted by his death must determine how those earnings will get out of the business to his widow. What makes him think that the business will declare a dividend for the first time in its history beyond what is need to pay income taxes?

The business owner who puts his ownership interest in trust for the benefit of his widow may mistakenly assume that the trustee will vote that ownership interest in favor of a dividend or distribution. There will not be a cash flow problem, they argue, because the stock will be voted in favor of a dividend.

Advise that client that it is the trustee who must vote the shares which are held in trust. If the trustee is a child who is active in the business, how likely is it that the trustee will vote in favor of a dividend at a time when the child believes the money needs to stay in the business? Certainly, the child/trustee has a conflict of interest (which I will address in the next section of this article); however, the real world intrudes to make unrealistic the assumption that the trustee will, of course, vote the trust shares in favor of a dividend.

Even if the surviving spouse is the trustee and can unilaterally vote the shares in favor of a dividend, what intrafamily disputes might arise in that situation? Perhaps some of the children are now the managers of the business and they argue that the business cannot afford a dividend at this time, particularly after the death of the entrepreneur. A widow who forces a dividend on the younger managers of the family business could easily create a family riot, particularly if the widow is a second childless spouse. I have seen three businesses get ripped apart within two years of the owner's death because of these exact family turmoils.

You may have an estate plan which mandates the distribution of "all the net income" to the surviving spouse from a credit trust and from a marital trust, but what "income" is really going to be available to distribute? If no dividends or other distributions are made from the business to the trustee, there will be no cash flow for the surviving spouse.

The business owner and his advisors need to address this critical issue as part of the succession planning/estate planning process.

Available alternatives include those non-business assets which will produce income after the business owner's death, including the proceeds of life insurance and the proceeds of any sale of an ownership interest pursuant to the provisions of a buy-sell agreement. Recall, however, that there may be no proceeds under the buy-sell agreement if ownership of the business is to stay within the family and if the transfers made by the deceased owner are permitted under the agreement with no stock to be purchased.

If the business is going to stay in the family after the death of the primary owner, he might give consideration to the acquisition of more life insurance as a way to create income producing assets for his widow.

Certainly the premiums will be expensive if the owner is elderly and he may no longer be insurable. Nevertheless, consideration of more life insurance may be appropriate.

If more insurance can affordably be acquired, the advisor should determine whether the new policy should be acquired by the business owner or by the trustee of an irrevocable life insurance trust. If the owner is the applicant and owner of the new policy, he may be making his own estate tax situation more complex. If, instead, he creates an irrevocable life insurance trust, gives to the trustee an amount equal to the initial premium cost and the trustee applies for and becomes the owner of the new policy, the proceeds will be paid into the irrevocable life insurance trust free of federal estate tax when the business owner dies.

Presumably, the widow will be the income beneficiary of the life insurance trust.

The business should give consideration to a deferred compensation plan, payable to the business owner upon his retirement and, more importantly, continuing for the rest of his widow's lifetime.

Finally, the business might today (while the owner is very much alive) create a written dividend policy to become applicable after the owner's death. It might provide, for example, that the business will declare a dividend or make a distribution to the owners in a stated percentage if earnings reach a certain level. If the business adopts this policy now, its later implementation will not be just at the widow's insistence, but will merely be carrying out the deceased owner's planning.

The issue of cash flow for a surviving spouse may be a case of the drafting driving the succession planning; that is, the mere drafting of a provision which mandates the distribution of "all the net income" to the widow should compel the planner and owner to address this critical planning issue.

THE TRUSTEE

Who will serve as the trustee who will carry out the estate plan? What conflict of interest problems exist for whoever serves as trustee?

Corporate fiduciaries

Corporate fiduciaries may be unwilling to act as trustee when the trust assets consist of an ownership interest in a family business. Bank trust departments do not want the liability which accompanies that responsibility. If the trust holds a controlling interest in the business, corporate fiduciaries are naturally aware of the management, as well as the fiduciary, responsibilities which the trustee will have.

Even if the trust will hold only a minority interest in the family business, many bank trust departments are reluctant to act as trustee and assume the state law duties of a minority shareholder in order to fulfill their fiduciary responsibilities to the trust beneficiaries.

If the business owner selects an individual to serve as trustee, he must identify a successor trustee in case the first selection is unable or unwilling to serve as trustee after the owner's death. The estate plan may include a string of individuals, with a provision calling for the beneficiaries to select a corporate fiduciary to act after all the named people have left the scene.

Before you routinely include this catch all provision in all of your estate planning documents, I recommend that you canvass the corporate fiduciaries in your market. Without disclosing any client confidences, you can reasonably inquire as to the policies of each bank trust department with regard to serving as the trustee of a trust which holds an interest in a closely held family business. Do not be surprised if most, if not all, of them state that they would decline to serve.

If your document mandates the selection of a corporate fiduciary after all the named individual trustees are unable or unwilling to serve, what does your local law state if you cannot find a bank trust department which is willing to serve? Does the local court then appoint the successor trustee? Is the business owner, whom you are advising on this critical issue, comfortable leaving that selection up to the local court having probate and trust jurisdiction? If not, consider other alternatives, such as permitting the beneficiaries to select the successor trustee, which does not have to be a corporate fiduciary, so long as the new trustee is not a beneficiary and is not related or subordinate to the beneficiary with the meaning of Code section 672(c).

The surviving spouse as trustee

So long as the trustee may distribute trust principal, in the trustee's discretion, only for the health, education, maintenance and support of the surviving spouse, there is no tax reason why the surviving spouse cannot serve as trustee. Nevertheless, there may be conflict of interest and family reasons why the surviving spouse may not be a wise choice as trustee.

The widow who serves as trustee may have a legitimate interest in her own cash flow, which can create conflict of interest reasons why it may not be the best idea to name the surviving spouse as trustee. The widow/trustee may vote the trust shares in favor of a significant dividend over the objections of those who are actually managing the family business. The trustee may be a significant or even a majority owner of the business, with fiduciary responsibilities under state law to the other owners of the business and to its employees, officers, and so forth. Those responsibilities imposed upon the trustee, as business owner, can be in conflict in conflict with the personal interests of the widow/trustee who seeks to enhance her cash flow.

The business owner who considers the spouse as a trustee candidate must also be advised that the widow/trustee may then be in a position to control the business. If the business owner is comfortable with this, there is no business reason not to name the spouse as the trustee. However, if this spouse has never been active in the business, is a second childless spouse or has a history of "instability," there may very well be a business reason why that spouse should not serve as trustee.

A child as trustee

It is tempting for the business owner to name as trustee that child who is going to manage the family business after the death of the entrepreneur. But what conflict of interest problems will that child have as trustee? It is more than likely that his or her responsibilities as the new manager of the business will come into conflict with the fiduciary duties which are imposed on the trustee.

The trustee, of course, has a fiduciary obligation to take those steps which are in the best interests of the beneficiaries of the trust. The manager of the business has an obligation to take those steps which are in the best interests of the business and its owners. Those two obligations can easily come into conflict over decisions about dividends or other distributions to the owners, expansion of plant, property and equipment, new business ventures, and so forth.

The key manager as trustee

Some owners prefer to name as trustee one or more key managers who have been with the business for decades. Who else knows the business as well and who else will be able to manage the business after the owner's death? That key manager will become the trustee and, as majority owner, will be able to run the business as the owner would have done if living.

However, this key manager also has the same fiduciary duties as trustee and manager. Added on top of those responsibilities may be a long friendship with the widow and some emotional guilt over the death of the owner while the key manager is still living. How will this key manager/trustee overcome the conflicts of interest and emotional conflicts when making decisions about dividends and so forth? How will he deal with his conflicting duties to the widow and the business?

Waiver of conflict of interests

If the business owner wishes to proceed with the naming of an individual trustee in spite of these conflicts of interest, it is important that the estate planning documents acknowledge and waive the conflicts. A draft clause is attached to this material for your consideration.

Removal of the trustee

It is critically important to give one or more of the beneficiaries the power to remove any corporate fiduciary which may be serving as trustee. With all that has happened in the financial industry over the years, no one wants to be held hostage by a trustee that cannot be fired. There are countless examples of a decedent who named his local bank as trustee, only for his widow to learn that she is now dealing with some gigantic bank in another state.

But what consideration should be given to the removal of an individual who is serving as trustee?

Today's trusted advisor may become an irrational, stubborn and even angry person as he or she becomes older. I have experience with situations in which a now elderly trustee became more and more autocratic and tyrannical over time. The power which a trustee has over the beneficiaries can be quite an aphrodisiac and one which is difficult to relinquish.

Should the business owner consider a stated retirement age for any individual who is serving as trustee?

There is anecdotal evidence that the old mandatory retirement age of 65 was selected in Germany by a wish to "retire" the older, senile generals who were over that age. Can a similar approach be taken with respect to the trustee?

If the business owner is reluctant to force a trusted colleague to retire as trustee due to age alone, can the beneficiaries be given the power to remove the trustee for stated reasons? For example, if the trustee arbitrarily refuses to exercise the discretionary power to distribute trust principal ("I don't care why you need money, the answer is 'no!'"), if the trustee arbitrarily abuses his powers as the majority owner of the business ("I forbid any expansion!") or if the trustee seeks to sell the family business over the objections of the beneficiaries, the document could grant to designated beneficiaries the power to remove the individual trustee for cause.

This type of removal for cause provision in the estate planning documents is preferable to the public need to seek the court removal of the trustee for cause; nevertheless, the trustee who refuses to relinquish his position ("I am not being arbitrary and the provisions of the trust agreement have not come into play based on my interpretation of the facts") may easily lead the family into court. Nevertheless, provisions of this type can be very persuasive to a judge who is seeking some insight into the business owner's intentions.

Co-trustees

Some business owners will select two individuals to serve as co-trustees, perhaps a family member serving with a key manager of the business. Depending on state law, it is likely that the decisions of co-trustees must be unanimous unless the document provides otherwise.

As the family member and the key manager will necessarily each have their own agendas, deadlocks between the co-trustees can be very possible. Whenever there is no unanimity between the co-trustees, that trustee who wishes to take a specific action loses. Each trustee is given a veto over the decisions of the other trustee.

One solution is to provide for tie-breakers in the estate planning documents. The business owner, for example, could provide that the decision of his key manager/co-trustee will control if there is a disagreement over management of the business and that the decision of the family member/co-trustee will control if there is a disagreement over discretionary distributions to family members. (If the family member/co-trustee is a beneficiary to whom discretionary distributions might be made, limits must be placed on his or her ability to exercise this power, so as to avoid having general power of appointment problems.) The disagreeing co-trustee must be relieved of liability for going along with the decision of the veto-holding co-trustee.

The estate planning document should be very clear as to the procedure if one of the two co-trustees resigns, becomes incapacitated or dies. Must there be a new co-trustee or may the surviving co-trustee continue to serve alone? Must there always be a representative of the family and a representative of the business serving together? If the surviving co-trustee may serve alone, does he or she then have all the powers of the trustee, including those over which the other co-trustee previously had a veto power?

The trustee who must follow the direction of a third party with respect to the business

In order to avoid the trustee's conflict of interest problems, the business owner might name one individual to serve as trustee, but give to a key manager or other third party the power to direct the trustee with respect to business interests that are held in the trust.

The trustee should be relieved of liability for complying with the written directions of this third party.

The document must specify what is to happen if the named third party resigns, becomes incapacitated, or dies. What is the mechanism for selecting a new person who can direct the trustee?

Consideration should be given to the power to remove this third party from the position of control.

The same considerations for removal for cause, discussed previously with respect to the trustee, arise in this connection. If the trustee can remove the advisor and can name a successor advisor for any reason, the trustee necessarily has liability for the actions of the advisor; therefore, the power to remove and to appoint a successor advisor should be given to one or more of the beneficiaries.

What limits should be placed on the powers of this independent third party? If the trust owns less than 100 percent of the ownership interests in the family business, should the trust instrument require the approval of a majority of the beneficiaries (the income beneficiaries only or include the remainder beneficiaries?) before certain corporate actions are taken, such as a pledge of corporate assets to secure a lone, a sale of the business or a majority of its assets and so forth?

Attached at the end of this outline is a sample provision on this issue.

TAX CHARGING CLAUSES

This little clause, infrequently reviewed, may cause untold problems for the estate planner. Too many advisors have a standard tax charging clause, which might have been developed years before, which is routinely used in all their estate planning documents. Pay all death taxes out of residue. That is what everyone wants. Right?

There are several reasons why the unilateral use of the typical tax charging clause, which imposes that burden on the residuary estate, may cause problems.

Non-probate transfers

Many clients today are planning to pass assets to the objects of their bounty using many different strategies, including jointly held property, POD accounts, beneficiary designations on investment accounts, revocable trust agreements, life insurance beneficiary designations, annuities, retirement accounts, irrevocable life insurance trusts, and so forth.

Are the beneficiaries who receive these non-probate assets the same as the residuary beneficiaries under the will? If so, it may not make much difference if the tax liability is imposed on the residuary estate, as the dollars all come from the same beneficiaries and in the same proportions.

But if some or all of the non-probate assets pass to beneficiaries who are not beneficiaries under the will's residuary clause, those residuary beneficiaries will find themselves paying the death taxes generated by assets which pass to other people if the entire tax liability falls on the residuary estate. They will not be happy with the estate planner who came up with this result, especially if there is no evidence that the tax charging clause and its consequences was discussed with the decedent.

The large specific bequest

Some estate plans include a large specific bequest which precedes the will's residuary clause. The business owner, for example, might want a specific gift of his business interest to that child who works with him and, to equalize, wants all his remaining assets to go to the non-business child.

The specific gift of the business interest will be free of any death tax liability and the non-business child will be expected to pay all the death taxes if the typical tax charging clause is used.

It seems reasonable to expect the estate planner to consider the taxes which might be generated by nonprobate transfers and large specific bequests and to have the client make a specific decision about who pays the tax liability.

Generation-skipping tax considerations may also come into play when the estate planner is writing the will or revocable trust agreement which creates a QTIP generation-skipping trust. If a reverse QTIP election is made when the first spouse dies, there may be a QTIP trust which is wholly exempt from generation-skipping tax and a second QTIP trust which will be subject to generation-skipping tax. Both the exempt and the non-exempt QTIP trust will be subject to federal estate tax at the subsequent death of the surviving spouse.

The planner should provide in the estate plan of the spouse who dies first that any tax liability resulting from the QTIP assets at the subsequent death of the surviving spouse must be satisfied first out of the non-exempt QTIP trust, so as to maximize the assets which remain in the QTIP trust which is exempt from generation-skipping tax.

If that language does not appear in the document which creates the first spouse's QTIP trust, there is some question whether the will of the surviving spouse can provide for the payment of that liability first from the non-exempt QTIP trust. Code section 2207A(a)(2) provides that the surviving spouse can waive the right to recover the additional estate tax generated by the QTIP trust assets; however, it does not expressly grant to the surviving spouse the power to direct how that tax liability is to be allocated within the QTIP trust itself.

Therefore, the preferred approach is to have in the document that creates the QTIP trust language that requires the additional estate tax payable at the death of the surviving spouse to be paid first from the non-exempt QTIP trust.

THE DIRECTION TO RETAIN THE BUSINESS OWNERSHIP INTEREST

The prudent investor rule in most states would require a trustee to liquidate any family business interest which is held in trust. Not only is the investment speculative, it almost always represents the most significant holding in the trust. We all know that putting all your eggs in one basket, let alone a speculative one, is not prudent.

Nevertheless, the business owner typically does not want the trustee to sell the stock. Neither do the beneficiaries. However, a disgruntled child later could seek recovery against the trustee for the trustee's failure to sell the family business interest which is held in trust.

To avoid this problem for the trustee and to accomplish the business owner's objectives, the estate planning documents should override the normal prudent investor obligations of the trustee. The will or trust agreement should direct the trustee to retain the ownership interest in the family business unless the trustee is directed in writing by specified beneficiaries to sell it.

I recommend that you not mandate the retention of the business interest in the estate planning documents. Who knows what wonderful buyout offer might come someday, long after your client has died?

Rather, I recommend that the language refer specifically to the holding by name, provide that the direction applies to any successor business and gives to one or more of the beneficiaries the power to direct the trustee's continued retention of the investment.

Language which merely gives the trustee the power to retain the original trust assets is not sufficient to relieve the trustee of this obligation to sell the business interest. The power to retain necessarily includes the power to sell. The wording should provide that the trustee must retain the business holding unless directed in writing by named beneficiaries to sell it.

The trust instrument should go on to relieve the trustee of any liability which the trustee might have as a result of the retention of this investment.

Coordinate the estate planning documents with the business succession documents

Lawyers who work in larger law firms find that their areas of practice become more and more focused over time. Estate planning attorneys may not be called upon to work with the business aspects of a family business owner; business lawyers may not be called upon to do estate planning work for their clients who own family businesses.

As a result of this concentration of practice areas, the estate plan and the business succession plan may not work very well together. There is no coordination.

Examples of this phenomena include buy-sell agreements that do not permit QTIP trusts for a surviving spouse (so deferrable tax must be paid when the first spouse dies), wills that include gifts that are not consistent with transfer restrictions in the buy-sell agreement and buy-sell agreements that prohibit lifetime gifts to descendants (so there is no ability to make gifts in an effort to shift future appreciation to the next generation).

It is important that the business lawyers work closely with the estate planning lawyers to coordinate the business succession documents with the estate planning documents.

Even if the business owners want a mandatory sale at death, consideration should be given to permitting lifetime transfers, perhaps in the form of irrevocable trusts, in an effort to permit the owners to shift future appreciation to subsequent generations and to take advantage of valuation discounts, so long as the buy-sell agreement mandated the sale of any gifted ownership interest by the trustee or other donee when the donor dies. This strategy will enable the owner to engage in tax saving maneuvers, while still adhering to the goal of a mandatory sale of each owner's interest at death.

If transfers to trusts for descendants are permitted under the buy-sell agreement, be certain that the estate planning documents are consistent with the business organization. For example, must the trusts be qualified subchapter S trusts, so as to preserve the entity's S election? If the trustee must also be a permissible transferee under the provisions of the buy-sell agreement, the estate planning lawyer must be certain that this requirement is carried out in the estate planning documents.

THE BUSINESS REAL ESTATE

Many business owners maintain separate ownership of the business real estate, which is then leased to the business. If the entrepreneur is married, the business real estate may be owned by the husband and wife in their joint names. If the entrepreneur is not married, the business real estate may be in his or her individual name.

Limit the owner's personal liability

If the real estate is separately owned, the real estate owner(s) has personal, unlimited liability for industrial accidents which might happen on the property.

I recommend that title to the business real estate be put into a newly formed limited liability company, owned by the person (or couple) who previously owned the business real estate, so as to limit the owner's liability to the assets of the LLC. His or their separate investment accounts should be protected from the personal liability that they have today.

A longer-term lease

Be certain that there is a written lease between the LLC and the business. Many leases I have reviewed have short terms, some as short as five years.

The risk of a short-term lease comes when the entrepreneur dies and the business is sold and moved to a new location. If the owner dies in year three of a five-year lease, the widow will be assured of continued rent payments from the purchaser of the business for only two more years.

If the buyer of the business were to move the business out of the location where it was previously, the widow may shortly find herself the owner of a very large, very empty building that is retrofitted for a particular purpose and which will be very difficult to re-lease or sell.

I recommend that the term of the lease be lengthened to as much as 20 years, with provisions for regular rent increases. If the business is sold and moved after the entrepreneur's death, the buyer will either have to continue the rent payments throughout the term of the lease or to buy out the lease. The latter (more common) approach is a way in which a portion of the purchase price of the business can be shared with the surviving spouse.

Give control of the real estate to the beneficiary who will control the business

Many business succession plans go to great lengths to give control of the family business to that child who works with the entrepreneur. The estate planning documents are frequently used to carry out this planning, typically in the form of specific bequests to the business child of voting interests in the business. The estate plan then may go on to leave all the entrepreneur's other assets to the non-business children in an effort to equalize the gifts.

If those "other assets" include the business real estate, the child who controls the business will find that he or she must seek the approval of siblings every time the business child wants to repave the parking lot, fix the roof or make any other change to the building and real estate on which the business is located.

If the business succession plan results in non-voting ownership interests being given to the non-business children, it is not unusual for them to refuse to consent to anything requested by the business child so long as he or she continues to take earnings from the business in the form of compensation and refuses to make distributions to all the owners of the business (including those who own the non-voting stock).

Why give that type of veto power to the non-business children? I recommend that control of the business real estate be given to that child who is given control of the business. Voting and non-voting interests can be utilized to give effective control, but not a huge dollar value, to the business child and an equivalent amount of non-voting equity to the non-business children.

EXIT STRATEGIES FOR OWNERS OF NON-VOTING INTERESTS

A common strategy to treat "fairly" the non-business children is to give them non-voting interests in the family business having a value equal to the voting interests given to the business children. But what favors are these business owners doing to the children who receive these non-voting interests?

A child who receives a stock certificate labeled "non-voting" will find himself or herself at the mercy of the business children; that is, the non-business child will receive dividends on this stock if and only if the business children declare a dividend. If the business children are taking much of the corporate income from the business in the form of compensation, the odds of a dividend stream to the non-business children are long.

A valuation expert may have concluded that the non-voting business interest has substantial economic value. But who would ever buy this non-voting interest? Indeed, a buy-sell agreement may permit its sale only to the company or other shareholders, who may have no interest in acquiring the non-voting stock.

Valuation experts may conclude that a minority interest discount in the range of 30-40 percent is appropriate when determining the fair market value of this ownership interest. I do not think that discounts in this range are sufficient. This stock really has no value in the real world where there is no income stream, no market to sell it and no intention ever to liquidate the business.

It is important to create an exit strategy for the owners of the non-voting interests in the family business. I recommend that the buy-sell agreement (or operating agreement for an LLC or the partnership agreement for an FLP) grant to the owners of the non-voting interest a "put," so that they have the option of demanding that the business or the owners of the voting interests buy them out over time with interest.

In a similar fashion, the children who own the voting shares can be given a "call," so they can force the non-business children to sell their non-voting stock whether they want to do so or not. If the business children are not given a call, the results all their efforts to grow the business will be shared by the non-business children who made no contribution to that success. If the owners of the voting shares were to buy the nonvoting shares over time, however, the conversion of this equity into debt would mean that the appreciation of the value of the business, attributable to the efforts of the owners of the voting stock, would inure solely to the benefit of the owners of that voting stock.

Once again, the buy-sell agreement can specify the purchase price to be paid for the non-voting shares, determined under a formula set forth in the agreement (which would specify whether the inherent value of the non-voting shares should be discounted for minority interest, lack of marketability and lack of vote), which would be paid to the sellers of the non-voting stock over a period of years with interest.

POSITION THE SURVIVOR TO GET VALUATION DISCOUNTS

Many owners of family businesses read about valuation discounts in trade journals. They become convinced that the value of their business for tax purposes will be reduced by 30 percent, 40 percent, 50 percent, or even more! Is this an accurate assumption?

The availability of valuation discounts depends on the ownership interest that is being valued. If the interest to be valued represents more than 50 percent of the equity in the business, no discount for minority interest will be available (although a modest discount for lack of marketability might be taken). The substantial discounts that our clients seek are available only if the interest to be valued is a minority interest in a family business with no market for resale.

When the surviving spouse later dies, his or her gross estate will include the stock which is held in the QTIP trust and the stock which is owned outright by the surviving spouse.

The Service attempted for years to aggregate these two blocks of stock, so that the combined stock will represent more than 50 percent of the equity in the business. The courts did not agree with this position, holding that each block of stock must be valued separately and independently from the other block. Estate of Bonner, 84 F3d 1996 (5th Cir. 1996); Estate of Lopes, T.C. Memo. 1999-225; and Estate of Mellinger, 112 T.C. 26 (1999). The IRS acquiesced in the Mellinger case. 1999-2 C.B. XVI, 1999035 I.R.B. 314 (August 30, 1999).

Each block of stock (one block is the stock held in the first spouse's QTIP trust and the second block is the stock owned by the surviving spouse) is valued independently. Because each block represents less than 50 percent of the equity, each block is entitled to discounts for minority interest and lack of marketability. (Remember that, after the first step, neither spouse owns even 50 percent of the equity; therefore, neither the QTIP trust nor the surviving spouse's own stock can be more than 50 percent of the equity.)

It is important for advisors to alert their clients who own family businesses that valuation discounts must be earned. If the ownership interest to be valued upon the death of a surviving spouse represents a majority interest in the business, valuation discounts will be insignificant.

The two steps listed above must be taken before the first spouse dies. If that first spouse stays with a plan that leaves more than 50 percent of the ownership interest in the business to the surviving spouse (outright or in a marital trust), it is too late; the surviving spouse's estate will not be eligible for valuation discounts unless he or she makes enough lifetime gifts to bring the ownership interest to less than 50 percent.

The QTIP trust can be limited to the first spouse's ownership interest, with other non-business assets left outright to the surviving spouse.

INCENTIVE PROVISIONS

Many owners of family businesses have heard stories about "perpetual students" and "trust babies."

They want the assurance that their children will not be able to stay in college for years and years as a benevolent trustee pays room, board, and tuition and they do not want their children to sit around the pool drinking margaritas while the same trustee willingly distributes principal to provide for their "maintenance and support."

The solution may be to include incentive provisions in the estate planning documents in the form of guidelines to the trustee. These guidelines can explain to the trustee the thinking of the business owner when he uses the terms "health, education, support and maintenance."

Health

Health might be generally understood to mean that the trustee can help pay for those medical expenses which are not covered by insurance. However, if the beneficiary knows that the trustee will pay for his medical expenses, what incentive does this child have to purchase medical insurance? Therefore, the guidelines might ask the trustee to obtain annual proof of medical insurance from the beneficiary, with the trustee to buy out of the trust assets a medical insurance policy for the child if he refuses to do so himself.

Education

"Education" can mean almost anything these days, as people go back to finish their degrees. But it can also mean that the trustee is expected to pay for whatever education the beneficiary wishes. To avoid the problem of "perpetual students," the guidelines could specify that the trustee is only to pay for a set number of years (say, five years) years for undergraduate education. If a beneficiary stays longer than that in college, he must pay for the expense himself.

If the trust benefits more than one child and if the assets are not substantial, there is the risk that the oldest child might deplete the entire fund if he or she attended an elite (i.e., expensive) college or university.

To prevent the trustee from inadvertently using most of the trust assets to educate one child, the guidelines could provide that the trustee can pay only what would have been paid had the child attended a specific state university where the parent resides; if the child is attends a more expensive institution, he or she must pay the excess cost himself or herself, through scholarships, student loans and part-time employment.

Remember that these are merely guidelines for the trustee. The business owner is saying to the trustee to follow these guidelines in a "perfect world." If unforeseen medical problems were to arise, for example, making the completion of a college education within the stated time impossible, the trustee has the flexibility to extend the guidelines.

Maintenance and support

"Maintenance and support" can mean virtually anything. It is difficult to imagine a beneficiary's need for money which cannot somehow be construed as being for his or her maintenance and support. In order to avoid the "trust baby" phenomena, the guidelines could provide that the trustee can only distribute an amount equal to (a larger multiple can be selected, of course) the beneficiary's earned income from the prior year for his "support and maintenance" after the beneficiary reaches a stated age, such as 21.

Some estate planning instruments contemplate the trustee's discretionary distribution of principal to enable the beneficiary to buy a home or to start a business. I have had experience with beneficiaries in their early 20s who expect the trustee to buy a home for them comparable to the home they grew up in. The guidelines could provide that the maximum amount which the trustee can distribute for each of these purposes is equal to the amount invested by the beneficiary. (Once again, a larger multiple can be selected.) If the beneficiary has his or her own money invested in this new business (and not just money from a parent's trust), I can almost guarantee you that the child's personal commitment to the success of this venture will rise dramatically!

Once again, these are merely guidelines. If the beneficiary were to become incapacitated or were to engage is a "socially useful, but underpaid profession" (such as an elementary school teacher or charitable worker), the trustee can exceed the guidelines. Care should be given when drafting these guidelines to ensure that the trustee will take into consideration the earning capacity of beneficiary's spouse. The business owner will not want the husband of his married daughter to stop working and to live off the trust merely because she is an elementary school teacher.

Guidelines about when scheduled distributions should be postponed

Some business owners want the assurance that the business will stay in the family. They know of today's divorce rate and are worried that some equity in the family business will end up in the hands of an ex-spouse.

It is possible to include a specific provision (not a guideline, but a requirement) that any scheduled distribution is to be delayed for a set number of years (say, 10 years) if the beneficiary marries prior to the scheduled distribution without a prenuptial agreement in place which will insure the business' staying in the owner's family. A provision of this sort may actually be useful to the child who is about to get married, as he or she can blame the need for the prenuptial agreement on their father!

Because prenuptial agreements can later be set aside for any number of reasons, the estate planning documents could go on to require the spouse of the beneficiary who is about to receive a distribution to execute a written, irrevocable disclaimer of any interest in the property that is about to be distributed and, failing that, the distribution is delayed for a set number of years.

Other, more discretionary, provisions can be included to provide additional guidance to the trustee. The estate planning documents, for example, might permit the trustee to delay indefinitely any scheduled distributions if the beneficiary is not engaged in "productive activities." Examples of the business owner's thinking must be included, of course, such as: (i) the child's failure to pursue an education in order to obtain meaningful employment; (ii) the child's refusal to support himself in a manner commensurate with his abilities; (iii) the child's abuse of drugs or alcohol; and (iv) the distribution will only be taken by the child's creditors in payment of unreasonable liabilities he has incurred. The instrument must release the trustee of any liability the trustee may have as a result of the exercise or non-exercise of these discretionary powers, with the trustee to be indemnified by the trust assets.

WHO CAN CHANGE THE PLAN?

When estate planners work with family business owners and consideration is given to the age or ages, at which an ownership interest in the business is to be distributed to the children, we are merely making educated guesses about what the future may hold. We have no idea whether the children will, in fact, be mature enough to "handle" the inheritance at the ages which appear in the estate planning documents.

It is possible to name an independent third person to serve as a "trust protector," who can actually direct the trustee to withhold or to accelerate scheduled distributions based on the facts and circumstances that exist in the future. Once again, the estate planning documents must expressly relieve the trust protector from any liability he or she may have as a result of the exercise or non-exercise of these discretionary powers and the trust protector should be indemnified by the trust assets.

Examples of the usefulness of a trust protector include the five-year delay in the scheduled distribution to a young woman, whose husband was ready to file for divorce the next day. He wanted half of the distribution to go to him as part of the property settlement. Another example is the young man who was scheduled to receive $300,000 on his 25th birthday; unfortunately, he was a drug addict. The trust protector (who was identified as whoever was the senior priest in the business owner's parish) refused to give him the money and checked the child into rehab.

Anything we can do to increase the flexibility of the estate plans we create is a good thing.

ASK ANOTHER LAWYER TO REVIEW YOUR "NEW" LANGUAGE

Clients often have specific requests which lead the estate planner to vary from his or her "standard" language. We actually have to come up with some new wording to accomplish our client's wishes!

I recommend that you always have another lawyer review this new language without telling him or her what the provision is supposed to say. Ask the other lawyer to read what you have written and explain what the other lawyer thinks it means. You may be surprised at how often the answer is not what you or the client intended.

The problem is that we know what the new language is supposed to mean and we believe that the words we have written accomplish that objective. But we know what this provision is supposed to mean!

Have someone read it who does not know what it is supposed to mean and see if his or her interpretation is consistent with your client's wishes.

Recall that most of these plans will someday be implemented by fiduciaries who did not attend the meeting between the client and the estate planner and do not know what the new language is supposed to mean; rather, they are left to figure out the documents on their own. That is why the input from another lawyer, who does not know what the answer is supposed to be, can be very helpful.

THE PROBLEM OF TOO MANY ADVISORS

Although this is not a drafting issue, it is one of the most pervasive problems which interferes with our goal of having family business owners actively engage in sophisticated business succession and estate planning. As much as we would like to think that we are our clients' most trusted advisor, the reality is that most family business owners have multiple advisors: a lawyer, an accountant, a financial planner, an insurance professional, a bank lender and so forth.

Suppose that you meet with a client to discuss several strategies for his or her consideration. The business owner leaves your office and runs into one of his other advisors. The business owner explains the strategies you have recommended (that's the first problem!). Even if the owner accurately describes the strategies, he is hitting the other advisor cold.

We live in a world where professionals limit their areas of practice. Suppose the other advisor is the business owner's CPA, who does a wonderful job on the business financial records and tax returns, but does very little, if any, estate or business succession planning. What is the likelihood that this other advisor will admit to his good client the fact that he does not know what the business owner is talking about?

Rather than admit the fact that he or she is not well versed in estate and business succession planning, the other advisor tells the business owner that "You don't need that." That is code for "I don't get it." What happens to your recommended strategies? You are dead in the water.

In an effort to minimize this very real problem, I recommend that you learn the identity of the business owner's other advisors. Who else is on the team?

If at all possible, I try to arrange a meeting of all the advisors without the family business owner being present. The advisors who meet with the client in a group setting almost always end up trying to impress the client, which is not terribly helpful. If the client is not present, on the other hand, most of that one-upmanship seems to go away. The advisors can then have a meaningful discussion of which strategies make the most sense for this particular client, taking into consideration each of their different perspectives. When the list of options has been narrowed down, the advisors can together meet with the business owner and present the team's recommendations.

When I have recommended this idea to my clients, I am almost always asked whether the client must pay for the advisors' time at this meeting. I explain that he or she, of course, will have to pay for our time, but that this may be the most productive use of fee dollars he or she has ever spent.

CONCLUSION

Working with family business owners can be very rewarding. There are complex interplays of business, family, tax, and emotional issues. No plan exactly replicates another because of the wonderful human elements with which we deal. But that is exactly what makes it fun!

These are real issues which must be dealt with by real people. It is our obligation to urge our clients to engage in this critically important work. It is too easy for business owners to adopt the Scarlet O'Hara approach to estate and business succession planning ("I will worry about that tomorrow, for tomorrow is another day!").

Our ethical requirement is to provide our clients with "competent representation." Rule 1.4 of the

Model Rules of Professional Conduct. For business owners we have represented for years, it is reasonable to conclude that estate and business succession planning are part and parcel of this competent representation we are expected to provide.

We each need to document for our files the continuing efforts we make to encourage our business owner clients to engage in this work. Too often the advice is oral and there is no record of the conversation in the lawyer's file. When the business owner dies without doing this work and the disaster you warned of becomes real, how can you convince the unhappy family that you had tried to get their father to engage in the strategies which they now (with 20-20 hindsight) understand could have prevented the problems.

This is very rewarding but critically important work we do!

FORM 1

Additional powers concerning retention of, investment in and exercise of powers with regard to closely held business interests

The Trustee is granted those additional powers as set forth below in this provision to retain interests in, to make investments in and to exercise powers with regard to the Settlor's closely held business interests (which interests include any interest in or indebtedness of any corporation, partnership, limited liability company, limited liability partnership, or other entity which at the time of the Settlor's death was at least __ percent (__%) owned, directly or indirectly, by the Settlor, the Settlor's spouse, the Settlor's descendants and the spouses of the Settlor's descendants) (hereinafter collectively referred to as the "Settlor's Closely Held Business Interests").

It is the Settlor's belief that the interests of all beneficiaries of any trust created under this Agreement, including all life beneficiaries and remaindermen, will be best served by the Trustee having the power to retain and invest in the Settlor's Closely Held Business Interests, even though such investments may lack liquidity, may be considered, and in fact be, more volatile or risky than alternate investments, may never yield a dividend or other income, and may constitute a very large percentage or all of the corpus of the trust. The Settlor realizes that retention and investment in the Settlor's Closely Held Business Interests may not be considered wise from a narrow financial or investment perspective.

The Settlor's evaluation of the best interests of the beneficiaries is based on broader considerations, including the emotional, social, and other intangible benefits of being associated with a family business. Accordingly, absent clear and convincing evidence that the Settlor's Closely Held Business Interests are in immediate danger of financial collapse, the Trustee is authorized to retain and invest in the Settlor's Closely Held Business Interests, irrespective of requirements for legal investment of funds and the duty to diversify investments or other fiduciary duties of the Trustee.

Further, the Trustee is expressly relieved from any duty to inquire into the financial or other status of the Settlor's Closely Held Business Interests, and the sole responsibility of the Trustee shall be to consider and respond to written suggestions by interested parties. No Trustee shall be accountable for any loss or depreciation in value sustained by reason of the Trustee's compliance with the Settlor's wishes or exercise of the powers granted as expressed above in this provision.

The Settlor has, or in the future may, name the Settlor's spouse and some of the Settlor's children or other descendants or their spouses as Trustee hereunder with full knowledge that, as trustees, they may exercise powers with respect to the Settlor's Closely Held Business Interests in which they will be individually interested as director, stockholder officer, employee, creditor, partner, or otherwise, and that they may as a result directly or indirectly benefit therefrom.

Further, the Settlor also anticipates that it may be desirable for any individual Trustee to make decisions, or refrain from making decisions, with respect to interests in the Settlor's Closely Held Business Interests, that are adverse in some respects to the short-term interests of some trust beneficiaries but which serve the long-term interests of the trust.

Accordingly, the Settlor fully authorizes any individual Trustee to act with respect to such matters in which a Trustee may be individually interested, or the resolution of which is in some respects adverse to the short-term interests of some trust beneficiaries, and the actions taken in these respects, absent clear and convincing evidence that the Trustee intentionally placed the Trustee's own interests above those of the trust, shall be as binding and conclusive as though no such relationship or conflict of interest existed.

Further, the Trustee is also granted additional power with respect to the Settlor's Closely Held Business Interests to participate in the conduct of any related business or to rely upon others to do so; to take or to delegate to others discretionary power to take any action with respect to the management and affairs of any such business interest which an individual could take as outright owner of the business or business interest, including the voting of stock (by separate trust or otherwise regardless of whether that separate trust will extend for a term within or beyond the date of final distribution of any trust created under this Agreement); to determine all questions of policy; to execute and to amend partnership agreements and other governing documents for other types of entities; to participate in and approve any primary or secondary offering of any such business or business interest on any stock exchange; to participate in and approve any recapitalization or reorganization of any such business or business interest; to elect or to employ with compensation, as directors, officers, employees, or agents of any such business, any persons, including the Trustee hereunder, without adversely affecting the compensation to which that Trustee would otherwise be entitled; to rely upon reports of certified public accountants as to the operations and financial condition of any such business, without independent investigation. In addition, a Trustee shall not be required to account for any such direct or indirect personal benefit that such Trustee receives, and shall not be liable for any resulting loss or depreciation in value that results, in either case or in the exercise of any of the foregoing powers granted in this provision, unless clear and convincing evidence exists that the Trustee placed the Trustee's interests above those of the trust and its beneficiaries.

The Trustee may not take any action under this provision or be in any way limited that would in any way jeopardize any Federal or state estate tax marital deduction for property passing at the Settlor's death and nothing herein shall contravene the Settlor's spouse's rights with regard to unproductive property held in the Marital Trust.

FORM 2

Powers of the business advisor

In the event the trust assets consist of an interest in a closely held business, the Trustee shall follow the written direction of ______________________ (the "Business Advisor") with respect to the management of this asset and the Trustee shall be relieved of liability for following that direction. This direction shall include, but not be limited to, the power to change forms of business entity, the power to continue the business, the power to retain net earnings for working capital in the business, and the power to make or consent to various tax elections with respect to the business interest.

If the business is unincorporated, the Trustee shall segregate the business from the other trust assets and shall treat it as a separate entity and shall account for the business interest in accordance with standard accounting practices.

If the Business Advisor were to request the Trustee to invest other trust assets in the business or were to request the Trustee to pledge other trust assets as collateral for loans made to the business, the Trustee shall follow that written direction without question or liability if the trust owns one hundred percent (100%) of the business; however, if the trust owns less than one hundred percent (100%) of the business, the Trustee shall follow that written direction of the Business Advisor only with the prior written consent of all the trust beneficiaries, including those who would be entitled to receive the trust assets if the trust were to terminate at the time the request is made by the Business Advisor (the "Beneficiaries") or, if that is not possible, with prior court authority.

The Business Advisor shall receive reasonable compensation for these services, payable in equal parts from principal and income of the trust.

If the initial Business Advisor shall be unable or unwilling to serve in this capacity, the Beneficiaries, acting by majority vote regardless of their pro rata interest in the trust, shall elect a new Business Advisor who shall have all the powers outlined above.