The Use of Trusts in Business Continuation and Succession

By Travis L. Bowen

Although trusts are used in many different contexts, this article will focus on the use of trusts in planning for business continuation and succession. First, it will highlight key issues that arise in drafting trustee powers to extend an owner's control or influence over a business after the owner's disability or death. Next, it will analyze the use of trusts to facilitate business succession when cross-purchase arrangements are used. Finally, it will discuss the use of trusts to hold S corporation stock. This article is only an overview, and the techniques discussed should be used only after thoroughly researching all related issues.

Drafting Trustee Powers

Business owners sometimes want to extend their control over a business after their disability or death, and there may be sound business reasons for doing so, particularly if the success of the business has been the result of the owner's particular abilities. This can be accomplished through the use of a carefully crafted trust.

As in all drafting situations, the use of precise language is essential. The danger of using ambiguous language is illustrated by the case of *Liberty Nat'l Bank & Trust Co. v. Albright,* 538 P.2d 620 (Okla. Ct. App. 1975). In that case the trust document at issue stated that it was the trustor's "desire" that the trustee "retain and continue to own" his company's stock and that the trustor's brother be retained as the company's manager. The trust further stated that this provision was a "precatory clause and not an absolute restriction on the powers of the trustee . . . ; however, [the] trustee *shall give due consideration to this clause* prior to disposing of any of the [stock], or prior to employing a manager other than [his] brother." Id. at 622 (emphasis added). Lastly the terms of the trust recognized that "changing conditions may warrant the sale of [the stock] or the employment of a different manager." Id.

After the trustor's death, the trustee hired the trustor's brother as manager of the company. Two years later, the trustee decided that it would be in the trust's best interest to terminate the brother as manager and dispose of the company's stock or its assets. Not willing to rely on the language of the trust alone, the trustee petitioned the court for a determination that it could do so. The brother disputed the trustee's right to discharge him, arguing that the trustee had not given "due consideration" to the language of the trust. The court ruled against the trustee, holding that, on remand, the trustee would have to prove its reasons for taking such actions in light of "changing conditions." This case illustrates how ambiguity in the fiduciary powers section of a trust can result in litigation and impair the management of a company.

The trust should also be drafted with sufficient flexibility to allow the trustee to protect the trust assets in the future. *In re Will of Killin,* 703 P.2d 1323 (Colo. Ct. App. 1985), is an example of what can go wrong if the powers are drafted too narrowly. In that case there was a general directive that the trustee maximize the income from its investments. But the trust also stated: "I direct that my ranch properties shall not be sold during the period of administration of this Trust, except such as may be necessary to sell for payment of taxes . . . ." Id. at 1325. At the time of the trustor's death in 1963, a ranch that was held by the trust was worth $88,274. Several years later, because of operating losses, the trustee sold the remaining cattle and ranch equipment, terminated the cattle ranching operations, and leased the ranch land for grazing purposes. By the early 1980s, the value of the ranch land was $2,332,000, but it was only producing approximately $5,000 of net income per year.

The trustee recognized that if the ranch land were sold, the income available to the beneficiaries would dramatically increase, and it sought a court order allowing it to do so. The trial court denied the trustee's request, and the appellate court affirmed. The appellate court relied on the fact that the trust did not state that the ranch was to be retained only so long as it was profitable. The court held that because the language was unambiguous and specific about the retention of the ranch land, that language controlled over the general direction to the trustee to maximize the amount of income from the trust's investments.

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Although courts have intervened and overridden the trustor's directives, those cases tend to involve unusual situations. In *Stout v. Stout*, 233 S.W. 1057 (Ky. Ct. App. 1927), the trustor directed the trustees to operate his whiskey barrel manufacturing factory after his death. The court allowed the trustees to discontinue that business because of the passage of Prohibition, which made the manufacture of whiskey barrels unprofitable. Similarly, in *N.J. Nat'l Bank & Trust Co. v. Lincoln Mortgage & Title Guaranty Co.*, 148 A. 713 (N.J. Ch. 1930), the trustee held mortgages as collateral security for bonds issued by a mortgage company. The trustee was directed to require the mortgage company to provide substitute mortgages in instances when mortgagors were six months or more delinquent. With the onset of the Depression and the abnormal number of mortgage delinquencies and foreclosures, it became impossible for the mortgage company to provide qualifying substitute mortgages. In that case, the court allowed the trustee to depart from the terms of the trust in response to what the court considered to be an emergency.

The Use of Trusts in Cross-purchase Arrangements

The buy-sell agreement, or buy-sell language in a partnership agreement or operating agreement, is the most common method used to achieve orderly succession in the ownership of closely held businesses. Trusts are sometimes used in connection with certain buy-sell agreements.

Buy-sell agreements are typically in the form of redemption agreements, cross-purchase agreements, or a hybrid of the two. Each type of buy-sell agreement has certain advantages and disadvantages, but, for corporate shareholders, cross-purchase agreements have several possible advantages over redemption agreements. Perhaps the most significant advantage, which applies to both C corporations and S corporations, is that in a cross-purchase arrangement the surviving shareholders receive a basis in the acquired stock equal to its fair market value. By contrast, with a redemption arrangement, the corporation purchases the stock of the deceased shareholder, and the surviving shareholders receive no increase in basis. Another advantage is that with a cross-purchase agreement a shareholder or a shareholder's estate can sell any amount of stock without the risk of the sale proceeds being treated as dividends, which may occur if a redemption agreement is used. In addition, unlike a redemption agreement, a cross-purchase agreement avoids the risk that the attribution rules might be applied to the transfer of stock to family members. Finally, if life insurance is used to fund the buy-sell agreement, a cross-purchase agreement will avoid the possible application of the alternative minimum tax or the accumulated earnings tax that might result if a redemption agreement is used and the corporation, as the beneficiary of the insurance policy, receives a large amount of insurance proceeds.

Cross-purchase agreements, however, can also have significant disadvantages. If the cross-purchase agreement is funded with life insurance, each owner must hold a policy on the life of every other owner. This can become complicated and confusing if there are more than two shareholders. This arrangement may also increase the likelihood that premiums will not be paid when due.

Also, the cross-purchase arrangement presents the risk that the insurance proceeds will not be used as intended. Because each shareholder holds policies on the lives of each of the other shareholders, when a shareholder dies, each of the surviving shareholders will receive insurance proceeds. Although the buy-sell agreement typically will obligate the shareholders to purchase the deceased shareholders stock, there is no mechanism that ensures that each shareholder will use the insurance proceeds for the purchase of the shares of the deceased shareholder. The shareholder may be tempted to use such proceeds for personal consumption or for other investments. If this occurs, the essential purpose of the buy-sell agreement will be frustrated, and the only recourse will be litigation.

The use of a trust offers a possible solution to both of these problems. In a "trusteed buy-sell" agreement the shareholders establish a trust with an independent trustee and with the shareholders' estates as the trust beneficiaries. The trustee holds the stock of all of the shareholders and is made the beneficiary of all life insurance policies. The trustee might even be given the responsibility of remitting premiums out of cash contributed to the trust.

The trust arrangement allows the shareholders to avoid the multiple-policy problem by having the trust simply purchase one policy per owner. This is sometimes referred to as an "OPPO Trust." More importantly, the trust arrangement provides a mechanism to ensure that the insurance proceeds will be used for their intended purpose. Because the insurance proceeds are under the control of an independent trustee, the proceeds will be used only to purchase the shares of the deceased shareholder.

On its face, this appears to be a simple solution to both problems. But a trusteed buy-sell agreement can cause more serious problems than it solves if careful attention is not paid to the income and estate tax issues associated with such arrangements.

Income Tax Issue with Trusteed Cross-purchase Agreements

The income tax issue that arises with trusteed cross-purchase agreements results from the "transfer for value" rules. Normally, life insurance proceeds are income tax free. But under the transfer for value rules of Code § 101, if a life insurance policy has been transferred for valuable consideration, the amount of the proceeds in excess of the amount of consideration paid will be taxable. In the following discussion of this issue, shareholders, partners, and members of limited liability companies may be referred to as "owners."

Buy-sell agreements funded with life insurance often involve transfer for value issues. An obvious transfer for

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value occurs when an insurance policy that has been previously acquired by an owner is transferred to the entity to fund a redemption buy-sell agreement. A less obvious type of transfer for value may occur in a cross-purchase arrangement when one of the owners dies. Because each owner holds policies on the lives of each of the other owners, cross-purchase agreements are often structured so that at the death of one of the owners, the policies held by the deceased owner are transferred to the remaining owners. This has the advantage of avoiding the need to purchase new policies, which will usually be at higher rates and which may not even be available because some of the surviving owners may be uninsurable at that time. But it has the disadvantage that the transfers may be deemed transfers for value.

Exceptions to the transfer for value rule prevent its application in some buy-sell arrangements. Even if there is a transfer for value, the insurance proceeds will retain their income-tax-free character if the transfer was to a partner of the insured, a partnership in which the insured was a partner, or a corporation in which the insured was a shareholder or officer. Code § 101(a)(2)(B). As a result of those exceptions, the transfer for value rule does not pose a problem in redemption arrangements when an owner transfers an insurance policy to the entity to fund the redemption agreement. Also as a result of those exceptions, the transfer for value rule does not pose a problem in cross-purchase arrangements when an owner (other than the shareholder) dies and that deceased owner's policies are transferred to the other owners.

Noticeably absent from the exceptions to the transfer for value rule is an exemption for transfers between shareholders of corporations or from corporations to their shareholders. As a result, the transfer for value rule is a significant problem with cross-purchase arrangements involving corporate shareholders. Although it seems that an OPPO Trust should avoid a transfer for value, that may not necessarily be the case. There is a risk that the transfer for value rule will apply at the death of one of the shareholders, because in such an arrangement the decedent's interest in policies on the lives of the surviving shareholders automatically shifts to the surviving shareholders. Although the law is not clear on this point, the IRS could take the position that a transfer for value occurs in that situation, even though the trustee is the legal owner and beneficiary of the policies at all times. However, it is unlikely that the IRS would prevail with such an argument.

If the shareholders desire to mitigate the risk described above, instead of using an OPPO Trust, the shareholders could each establish a trust using the same trustee to acquire (and be the beneficiary of) policies on the lives of all of the other shareholders. At the death of a shareholder, the trustee would terminate the policies it had purchased for that shareholder on the lives of the surviving shareholders. The trustee could then increase the amount of coverage on the remaining policies, or acquire new policies, to make up for the insurance that had been terminated. Although the multiple-policy problem would not be avoided, the shareholders would ensure that the insurance proceeds are used for their intended purpose.

Estate Tax Issues with Trusteed Cross-purchase Agreements

The estate tax issue that arises with trusteed cross-purchase agreements results from the possible application of Code § 2042, which provides that life insurance proceeds may be included in the estate of the insured if the insured has incidents of ownership of the policy. The IRS has taken the position that, in a trusteed buy-sell agreement, if the insured has the right to revoke or amend the trust, the insured will have an incident of ownership that results in the policy or policies on his life being included in his estate for estate tax purposes. See PLR 9309201, 9235029, 199903020, and 199905010. This could result in double taxation, because both the value of the stock and the amount of the insurance proceeds could be included in the shareholder's estate.

The most obvious way to avoid this problem is to make the trust irrevocable. Some shareholders may be concerned that an irrevocable trust arrangement is inflexible. By giving the trustee flexibility for the purchase, replacement, and termination of insurance policies, these issues are often mitigated. Giving the shareholders, by majority vote, the right to remove the trustee and appoint a different trustee who is more likely to take a particular action the shareholders desire may also provide flexibility.

If the shareholders form a separate partnership to purchase and be the beneficiary of the life insurance policies, the transfer for value rule might be avoided and the advantages of a trust arrangement preserved. Because the transfer for value rule does not apply to transfers to a partner of the insured or to a partnership in which the insured is a partner, such an arrangement, if properly structured, solves the transfer for value problem. But this approach has disadvantages. First, the partnership must actually be a legitimate business that is engaged in an enterprise. Second, on the death of a partner, the amount of the insurance proceeds will increase the basis of all of the partners, including that of the deceased partner. The actual insurance proceeds, however, will only be distributed among the surviving partners. As a result, the basis of each surviving partner in his partnership interest may not increase sufficiently to offset the amount of insurance proceeds distributed to him. Third, because of the insured partner's rights as a partner, he risks being deemed to have incidents of ownership in the policy, resulting in the inclusion of the proceeds in his estate for estate tax purposes.

In summary, a trust is a vehicle that deserves serious consideration in the context of business succession through buy-sell agreements. It should be used, however, only after carefully considering its advantages and disadvantages in the particular context and the other alternatives that may be available.

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The Use of Trusts to Hold S Corporation Stock

Use of a trust to pass ownership of S corporation stock may allow the trustor to exercise a degree of control over the corporation after his or her death through directions given to the trustee. Because of the limitations that apply to the ownership of S corporation stock, however, care must be taken in choosing and structuring the appropriate type of trust. Although several types of trusts can hold S corporation stock, this article will only discuss two such trusts.

The most common type of trust used to hold S corporation stock is the Qualified Subchapter S Trust, or "QSST." To qualify as a QSST, the following requirements of Code § 1361(d) must be met:

- There must be only one income beneficiary (who must be a U.S. citizen);
- The income beneficiary must receive all of the trust income annually;
- Any principal distributed during the income beneficiary's life must be distributed to the income beneficiary;
- The trust must terminate on the earlier of the death of the income beneficiary or on some other pre-determined date;
- Upon termination of the trust during the beneficiary's life, the trust must distribute all of its income and principal to the income beneficiary; and
- The income beneficiary of the QSST must affirmatively elect to have the trust treated as a QSST for the stock of each S corporation held by the trust.

If any of the above requirements are not met, the Subchapter S election will be terminated.

Several other special considerations apply to drafting and structuring QSSTs. First, to avoid the application of statutory default provisions that could destroy QSST status, consideration should be given to whether any modification of the state's principal and income act is needed. Second, care should be used in drafting special powers of appointment. The QSST should not include an inter vivos special power of appointment, because such a power may disqualify the trust by allowing income to be paid to a person other than the income beneficiary. If a testamentary special power of appointment is used, the permitted appointees should be limited to persons (of type and number) who are eligible S corporation shareholders. Finally, to help safeguard QSST status, the trustor should consider appointing either a nonbeneficiary trustee or a co-trustee for the purposes of making distributions from the trust. Before drafting a QSST the practitioner should carefully review Code § 1361 and Treas. Reg. § 1.1361–1(j).

Another type of trust that can hold S corporation stock is the Electing Small Business Trust (ESBT). The ESBT offers substantially more flexibility than a QSST. Unlike the QSST, the ESBT may have multiple income beneficiaries, and it can be a "spray" trust for the benefit of a surviving spouse and children. In addition, the trustee of an ESBT may have discretion in making distributions and accumulating income for future distributions.

To qualify as an ESBT, the following requirements under Code § 1361(e) must be met:

- Each beneficiary must be an individual, an estate, or a charitable organization described in Code § 170(c)(2)–(5);
- Interests in the trust must be acquired by gift, bequest, or other nonpurchase transaction;
- The trustee of the trust must make a timely ESBT election, which can only be revoked with the consent of the IRS; and
- Each of the "potential current beneficiaries" must be individuals or estates that otherwise are eligible to be S corporation shareholders.

"Potential current beneficiaries" are defined as persons who are entitled to, or may at the discretion of any person, receive principal or income distributions during any tax period. The rules for ESBTs are set forth in Treas. Reg. § 1.1361–1(m).

An important consideration in determining whether to use an ESBT or a QSST is its income tax treatment. For federal income tax purposes, income from S corporation stock held by an ESBT (other than stock to which the grantor trust rules apply) is taxed at the highest trust rate (38.6% in 2002), but income from a QSST is taxed at the income beneficiaries' rates.

Certain special considerations apply in drafting and structuring ESBTs. First, because each potential current beneficiary of an ESBT is counted as a single shareholder of the S corporation and an S corporation can have no more than 75 shareholders, the terms of the trust should limit the number of current beneficiaries accordingly. Second, including an inter vivos or testamentary power of appointment will disqualify an ESBT unless permitted appointees are limited to eligible shareholders of S corporation stock. In addition, careful attention should be given to the new treasury regulations effecting ESBTs as they affect not only the types of beneficiaries but also the manner and type of elections that can be made.

Conclusion

Trusts continue to be versatile planning tools in many business contexts. They can allow business owners to extend their control or influence over the affairs of the business after their disability or death, and they can facilitate the orderly transition of business interests when used in conjunction with cross-purchase agreements. Trusts can be used with all types of business ownership interests, including S corporation stock, but it is essential that they be structured and drafted carefully and that all relevant issues, including those discussed above, be taken into consideration. ■

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