ESTATE PLANNING FOR BUSINESS OWNERS

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I. INTRODUCTION. Colorado, more than most states, is dominated by closely-held businesses. Devising an estate plan that provides adequately for the continuation, sale or liquidation of the business on the death of the owner or owners often presents the greatest challenge to business advisors. Often, it is difficult even to persuade our clients to focus on the issue until a crisis looms or an emergency triple-bypass reminds them of their frailty. Most people in business want to focus on their business and are often frightened of the possibility of losing it. Planners can help their clients overcome their fears and develop a business succession (or preservation) plan. To do so, we have to become both amateur psychologists and salespeople of sorts, conveying not just the features and tax saving potential of the planning techniques we are trying to sell, but the benefits, here and now, to our clients.

II. SUCCESSION PLANNING.

A. What is Succession Planning? Succession planning is an umbrella term covering a variety of strategies used to ease the transition of a business from one owner to the next. A succession plan may involve easing the younger generation into management and ownership while setting aside an equivalent piece of the pie for children without interest in or aptitude for the family business. By contrast, it may involve an "exit" strategy under which the ownership group sells out, perhaps using a tax-effective planning technique such as an employee stock ownership plan ("ESOP").

B. Why Have a Succession Plan? A succession plan can

1. Ensure that a business will stay in existence following the departure, whether planned or sudden, of a principal;

2. Protect the interests of owners, both those active in the business and passive investors;

3. Free up some assets of the business for the owner's personal enjoyment;

4. Provide retirement benefits to owners as well as rank and file employees;

5. Encourage employee loyalty;

6. Permit principals to reduce their roles in the business and pursue other interests.

C. Common Succession Planning Techniques. The most popular techniques for business succession planning include these:

1. Creating voting and non-voting interests;

2. Making gifts of interests in the business, taking advantage of valuation discounts, most importantly, for lack of control (minority discount) and lack of marketability;

3. Preparing for a sale, which might include a sale to an related third party, to insiders or to the public through an initial public offering;

4. Selling all or part of the business in an installment sale, perhaps with a self-canceling installment note ("SCIN") or by means of a private annuity;

5. Separating various aspects of the business, for example, by setting up a separate company to hold real estate or equipment to be leased to the operating business or intellectual property to be licensed to the operating business or to third parties;

6. Carving our special roles for future managers as well as for family members who are not active in the business;

7. Giving part or all of the business to charity, perhaps through a charitable remainder trust or family foundation;

8. Creating an effective buy-sell agreement to permit future owners to buy-out family members;

9. Using life insurance to satisfy liquidity needs;

10. Establishing qualified retirement plans and non-qualified deferred compensation plans to provide future income to a retired shareholder or her family.

III. VALUATION ISSUES. The amount of transfer tax to be paid ultimately rests on the valuation of the property transferred. Code §§ 2031, 2512 & 2624. Valuation of a business interest is often the key to a successful business succession plan. The value of property for transfer tax purposes has always been based on the hypothetical willing buyer and willing

seller, neither being under any compulsion to buy or sell and having reasonable knowledge of the relevant facts. Reg. § 20.2031-1(b); Reg. § 20.2512-1. The basic steps in valuing a business are set forth in Rev. Rul. 59-60, 1959-1 CB 237, which remains the guiding in this area today. However, Congress has introduced a variety of special valuation rules, such as special use valuation under Code § 2032A, and more recently the special deduction for family business interests under Code § 2057. In addition, use of different types of business entities and the division of business into parts that prove to be worth less than the whole have created the possibility of prolonged and expensive valuation battles. The Service continues to try to place limits on taxpayers' use of what are viewed as creative valuation techniques.

A. Working with the QFOBI. While not a valuation technique, the QFOBI deduction has become intimately connected to the valuation and appraisal approaches taken in an estate. Working with the QFOBI can be cumbersome and frustrating. Word has it that the complexity in the statute resulted from an effort by the drafters to calibrate the revenue impact. Because the QFOBI will be repealed in 2004, the following discussion may prove to be of academic interest only.

1. What is a QFOBI Anyway? Beginning in 1998, the estates of decedents who materially participated, or whose family members materially participated, in a family–owned business (a "qualified family-owned business interest", or "QFOBI") in five of the eight years before death receive an additional estate tax benefit under what was originally enacted in 1997 as Code § 2033A. As originally enacted, § 2033A provided for an exclusion of the value of a business that, in combination with the unified credit, allowed up to $1,300,000 to pass to family members free of estate taxes. The 1998 Internal Revenue Service Restructuring and Reform Bill Pub.L.No.105–206 redesignated Code § 2033A as § 2057 and changed the original exclusion to a deduction, thus increasing the benefit to the estate by subtracting the value of the family–owned business (up to $675,000) at the highest, rather than lowest, marginal tax rate. An estate in the maximum 55% tax bracket could, therefore, save as much as $362,000 in taxes. The potential tax savings decreases with the increase in the estate tax exemption amount § 2057 freezes the applicable exclusion amount at $625,000 for estates taking full advantage of the QFOBI deduction. By 2006, the potential tax savings shrink to $227,500, still hardly an amount to be sneezed at. As it now reads, the QFOBI provision makes it clear that the deduction applies only for estate tax purposes and not for gift tax or generation–skipping tax purposes.

2. Requirements. Determining whether a business is a QFOBI requires fairly complicated calculations and assumptions. To qualify as a QFOBI, the business in which the decedent held an interest must meet these criteria:

a. The decedent or members of the decedent's family (an ancestor, spouse or a lineal descendant of the decedent, a lineal descendant of the decedent's spouse, or of a parent of the decedent) must have "materially participated in the business for five of the eight years before death. Code § 2057(b)(1)(D). The material participation test comes from Code

§ 2032A(special use valuation); it mandates being involved in the business on a daily basis and participating in management decisions.

b. Qualified family members must continue to operate the business. While it is possible to qualify for the QFOBI deduction when a qualified heir is not a U.S. citizen, in that circumstance the business must be held by a trust, similar to a qualified domestic trust, to ensure that the estate tax will ultimately be paid. Code § 2057.

c. The principal place of business must be located in the United States. Code § 2057(e)(2)(A).

d. The business must have been at least 50% owned by the decedent and family members, 70% owned by members of two families, or 90% owned by members of three families. This test refers to both voting power and total value of stock in a corporation, and to capital interests in a partnership. Code § 2057(e).

e. No more than 35% of the business's adjusted gross ordinary income consists of personal holding company income in the taxable year that includes the date of the decedent's death. Code § 2057(e)(2)(C). For this purpose, income generated by a net cash lease of property to a family member will not be treated as personal holding company income.

f. The decedent must have been a citizen or resident of the United States on the date of death. Code § 2057(b)(1)(A).

g. The sum of the "adjusted value" of QFOBIs plus "includible gifts" must exceed 50% of the adjusted gross estate. The "adjusted value" is determined by taking the fair market value of the business interests and reducing them by the excess of claims against the estate and debts of the estate over the sum of qualified residence debt, debts incurred to pay educational or medical expenses of the decedent, the decedent's spouse, or dependents, and any other debt that does not exceed $10,000. The concept of "INCLUDABLE gifts" allows the estate to add to the value of the QFOBI gifts of qualified property that the decedent made to family members after 1976, provided that the family members still own the gifted property at the time of death. Code § 2057(b)(1)(C). The "INCLUDABLE gifts" increase both the value of the QFOBI and the adjusted gross estate, whereas other gifts to family members, including gifts made to a spouse within ten years of the date of death and to other family members within three years, increase only the adjusted gross estate. This restriction discourages taxpayers from manipulating their holdings through selective gifting to qualify for the deduction.

h. The executor or personal representative must elect to apply the QFOBI deduction and file a written agreement consenting to the application signed by every person who has an interest in the property. Code § 2057(h).

3. Recapture. Some or all of the § 2057 tax benefit must be recaptured and repaid to the Service if (i) the business is disposed of within 10 years of death, (ii) no qualified heir or family member continues to meet the material participation requirement; (iii) the qualified heir loses his or her U.S. citizenship, or (iv), the principal place of business is no longer located in the United States. Code § 2057(f). The estate tax potentially subject to recapture equals the difference between the estate's actual tax liability and the amount it would have owed if the family-owned business election had not been made. If the property has been held for six or more years, the recapture is phased out at the rate of 20% per year. Code § 2057(f)(2)(B). Recapture is not triggered by a transfer of the property to another qualifying family member or by creation of a qualified conservation easement. Code § 170(h).

4. Planning Tips.

a. Consider revising shelter trust provisions for owners of closely-held businesses to permit the allocation of the unified credit amount plus the family-owned-business deductible amount to the credit shelter trust.

b. Taxpayers who may be eligible should keep thorough records of gifts made to family members to ensure that the 50% threshold will be met.

c. Document family members' participation in the business. Make sure that they receive salaries or self-employment income. It is often difficult to come up with sufficient evidence if the determination is deferred until after death. *See* Gary L. Maydew, *Material Participation – The Court's Interpretation*, Journal of Agricultural Taxation and Law, Winter 1986.

d. Monitor the value of the business and other assets and liabilities frequently to ensure continued availability of the deduction. It may make sense to use investment assets to pay off business debts to increase the value of the business.

e. Because the business must be an operating business, avoid accumulating cash or investment assets in excess of reasonable business needs and document the business needs using a *Bardahl* formula.

f. Ascertain whether the heirs really want to or are capable of continuing to run the business after the owner's death.

g. Ensure that life insurance will not be part of the taxable estate by having it owned by third parties or a life insurance trust.

h. Consider shifting ownership of business and non-business assets between spouses to satisfy the QFOBI requirements for one or even both spouses.

i. Don't let planning for the QFOBI deduction discourage healthy diversification and succession planning.

j. Consider allocating the liability for estate taxes (particularly the recapture tax) to the people who inherit the business.

B. Family Limited Partnerships and Limited Liability Companies. Partnerships have been used to operate closely-held businesses for centuries. Recently, they, and their pass-through cousins, limited liability companies, have attained new popularity, not to say notoriety, as estate planning tools. They are touted as a means to permit the senior generation to pass on a business to the younger generation while maintaining control of the assets and income. The "Family Limited Partnership" ("FLP") serves a variety of important business and tax saving purposes; it facilitates centralized asset management, increases control while enabling control to be transferred, and achieves administrative savings. Precisely because minority owners to whom partnership interests are transferred have less control than they might in a corporate or joint-ownership setting, their interests are also worth less than they might be otherwise, and discounts for minority interest, lack of control and lack of marketability are clearly justified. The Service has even conceded that minority discounts may apply even where all interests in a partnership are owned by a single family. Rev. Rul. 93-12, 1993-1 CB 202. Although Code §§ 2701 through 2704 require us to jump through a number of hoops to justify valuation of businesses in the family contest, valuation discounts remain firmly implanted in the pantheon of the transfer tax system. By the same token, we can anticipate that the Service will continue to challenge valuation discounts that are not carefully documented.

C. Corporate Stock. In recent years, the corporate form has lost favor with estate planners. The use of a preferred stock bailout to freeze the value of the senior generation's stock has gone by the wayside and the popular thinking is that pass-through entities, limited partnerships and LLCs, provide a greater opportunity for valuation discounts, as well as a stepped-up basis on death. Recent case law indicates that corporate stock may also be legitimately valued at a discount, resulting in a transfer of a business at a lower estate tax cost.

1. Discounts for Future Capital Gains Taxes. In *A. Davis Estate,* 110 TC 530 (1998), the Tax Court rejected the Service's (and the Tax Court's) long-held position that the value of corporate stock may not be reduced by the potential tax to be paid on unrealized capital gains. The Second Circuit shortly followed suit in *Eisenberg v. United States*, 155 F3rd 50 (2d Cir. 1998), revoking and remanding 74 TC Memo. 1046, TC Memo. 1997-483. In 1999, the Service acquiesced in the result in *Eisenberg*, at least to the extent of

acknowledging that the law does not prohibit recognizing a discount with respect to built-in capital gains taxes. Action on Decision. CC-1999-0001 (February 1, 1999). More recently, *H.B. Jameson Est.*, 77 TC Memo. 1383, TC Memo. 1999-43, following *Davis*, permitted an estate to value stock in a C corporation at a discount where the major asset was appreciated timberland.

Before the repeal of the *General Utilities* doctrine by the Tax Reform Act of 1986, it was possible to avoid capital gains tax on liquidation of a C corporation. In today's world, the taxes can no longer be avoided and thus, must be recognized as reducing the value of a business. However, it took some time (13 years) for the Service to come around to this viewpoint. In 1991, the Service reaffirmed its view, stating in TAM 9150001 (August 20, 1991), that a reduction for future taxes is too speculative to be warranted where there is no provable intent to liquidate the assets or the corporation. The narrowness of the Action on Decision and the approach taken in *Jameson* make is clear that thorough use of experts will be necessary to establish the amount of any available discount. In *Jameson*, the Court adopted a discounted cash flow approach to come up with the tax liability that would be associated with the harvesting and sale of the timber, resulting in approximately a 12% discount from the net asset value. With respect to other kinds of property, other approaches may be appropriate. In any event, if a sale is not imminent, the future sale date could be estimated, using reasonable assumptions, and the tax consequence discounted to present value. Another approach could involve comparing the relative cost of public shares in C corporations and in pass-through entities holding similar businesses. Outside of the real estate arena, in which publicly-traded REITS offer a ready comparison to publicly-traded real estate companies, there are no publicly-traded pass-through vehicles to use as a point of comparison. Clearly, using a well-qualified appraiser will be critical to obtaining the best possible discount in these circumstances. Of course, minority discounts and discounts for lack of marketability will, as in the past, play into the final value of corporate stock for gift or estate tax purposes.

2. The Role of Minority Shareholders. In addition to the capital gains tax discount, *Jameson* also considered the impact of a minority shareholder's pesky presence on the value of the 97% shareholder's stock. The taxpayer's experts argued that the 3% owner, who was the decedent's son and president of the company, could interfere with a potential sale of the company, thus reducing the value of the 97% shareholder's interest. Not surprisingly, the Tax Court sided with the government in dismissing the notion of a "nuisance discount".

Not long after *Jameson*, Judge Laro, one of the Tax Court's most influential judges on valuation issues, muddied the waters in *Estate of Kaufman*, TCM 1999-119. The question at issue there was the value of 21.51% interest in a largely family-owned corporation. While not a controlling interest, the decedent's block of stock was the biggest of the 15 shareholders'. Judge Laro's opinion appeared to acknowledge the possibility of a "nuisance discount" in a closely-held corporation and considered the possible difficulties the decedent would have encountered in attempting to sell his interest outside the existing current shareholders, all of whom were family members, employees, or both. However, the decedent in question was

nonetheless found to be in control and the taxpayer's attempt to obtain a discount was thwarted.

***Estate of Simplot*, 112 TC 130 (1999), a reviewed decison written by Judge Jacobs, considered the value of the decedent's interest in two classes of stock, 23.55% of the voting stock and 2.79% of the nonvoting shares. As in *Jameson* and *Kaufman*, the other shares were held largely by family members, plus an ESOP. As in *Kaufman,* the decedent's interest was a minority one, yet the court still held that a control premium should apply because a potential buyer of the voting stock could potentially become the owner of the largest block of voting shares in the future. This analysis reflects the "swing vote premium", a still emerging area of valuation theory. The holding was reversed by the Ninth Circuit Court of Appeals with the conclusion that no premium may be attributed to the swing vote potential of a minority intererst. *Simplot v. Commissioner*, 249 F.3d 1191 (9th Cir., May 14, 2001)**

***Estate of Mellinger*, 112 TC No. 4 (1/4/99), acq. ADD 99-006, 1999-35 IRB 314 dealt with the infamous Frederick's of Hollywood, a corporation 56% of whose stock was owned by a husband and wife as community property. The husband's half was placed in a QTIP trust on his death. The other half was held in the wife's revocable trust. On her death, of course both halves were included in her estate under Code § 2033. The Service argued that the two halves must be aggregated and treated as a controlling interest; thus, no minority discount would be available. The Tax Court disagreed; the fact that QTIP property was included in the surviving spouse's estate did not mean that she had ownership and control over it.**

***Adams v. United States*, No. 99-10497 (5th Cir., July 5, 2000) found that a decedent's partnership interest was only an assignee interest, not a full-fledged partnership interest, and should be discounted accordingly. The Court noted that the assignee "could be stuck with an unmarketable interest in a partnership that owns a poorly diversified mix of assets and over which the assignee has no legal control. If this proved to be the case, the fair market value of the 25 percent assignee interest would be substantially less than a straight, ratable 25 percent hsare of the partnership's NAV, thereby reflecting these undesirable characteristics. More to the point, the legal uncertainty that obscures the extent, if any, to which an assignee has the right to provoke liquidation or, alternatively, to force a straight pro rata redemption of his interest, suggests that any effort to exercise such putative rights would be met with strong resistance from the remaining partners." The matter was remanded to the lower court for further consideration of these factors, all of which point to a significant discount from net asset value. On remand, the District Court upheld a 20% minority interest discount, a 10% portfolio discount and a 35% lack of marketability discount.**

***Estate of True v. Commissioner*, T.C. Memo. 2001-167 (July 6, 2001) presents a lengthy discussion of the use of buy-sell agreements to set values for estate tax purposes, with the end result that the IRS is not required to accept such agreements as controlling. The Tax Court found that the buy-sell agreements were not business agreements, but rather testamentary devices, intended to transfer interests in the family business to younger generations.**

Clearly, valuation of closely-held businesses promises to continue to provide us with a wealth of litigation. When planning the estates of business owners, we should always be prepared to litigate, armed with the most thorough valuation analyses we can obtain (at the price our clients are willing to pay). In planning, probably the most useful technique will be to divide and conquer.

3. Byrum Revisited - TAM 199938005. In September 1999, the estate planning world was astounded by the Service's finding that the value of stock transferred to a family limited partnership remained INCLUDABLE in his gross estate under Code § 2036(b) because he had a right to vote the stock as general partner. In TAM 199938005 (September 27, 1999), two brothers with equal interests in the stock of a corporation, placed part of their stock into a family partnership for what appear to have been legitimate business (i.e., non-tax) reasons. The brothers received both general and limited partnership units. The decedent promptly transferred his limited partnership units to his children. Under the terms of the FLP agreement, the partnership, under the direction of the general partners could vote the corporate stock; if the general partners were deadlocked, each individually could vote the number of shares proportionate to his general partnership interest.

D. Reporting Valuation Discounts to the IRS. Final Treaasury Regulations §§ 20.2001-1, 25-2504-2 and 301.6501(c)-1 offer the protection of the statute of limitations on revaluation of gifts provided that the taxpayer gives the IRS a road map to the valuation method used. A transfer will be considered adequately disclosed only if the gift tax return includes a description of the transferred property, the identity of, and relationship between, the donor and the donee and identifying information of any trust involved. Gift tax returns must either attach the usual appraisal or provide a detailed description of the method used to determine the fair market value of the property, whether discounts have been taken and the relevant facts about the transfer that may reasonably be expected to apprise the IRS of the nature of any potential controversy concerning the gift tax treatment or a concise description of the legal issues presented by the facts. A statement of any position taken that is contrary to any temporary or final regulation or revenue ruling must also be submitted.

E. Challenging the Estate Tax Value as Income Tax Basis. Although clearly limited to unusual circumstances, TAM 199933001 confirms that an estate beneficiary may be able to claim a different basis for inherited stock than the value reported on the estate tax return. In the ruling, the taxpayer's inherited one-sixth interest in corporate stock was redeemed by the corporation. The taxpayer claimed a tax basis equal to the redemption price and thus reported no gain or loss. Because the taxpayer was able to demonstrate that the redemption price represented fair market value for the stock, and he had no part in the preparation of the estate tax return, he was not precluded from taking a position at variance from that taken by the personal representative. *See* Rev. Rul 54-97, 1954-1 CB 113 and *R. Shook*, 83-2 USTC ¶ 9564 (11th Cir. 1983).

IV. PLANS GONE AWRY - RECENT ASSAULTS ON BUSINESS SUCCESSION SCHEMES.

A. The "Common Business Organization Trust", the latest incarnation of an old ploy. Western and Midwestern states seem particularly susceptible to what has variously been known as the "family", "constitutional" or "pure" trust, and most recently as the Common Business Organization Trust. A recent Tax Court Memorandum decision illustrates the pitfalls of these schemes. Dr. George practiced osteopathic and homeopathic medicine from his home in Scottsdale, as well as at other locations. In 1993, on the advice of a Mr. Chisum, who was neither a lawyer nor an accountant, but rather a self-styled "consultant on establishing and operating trusts", Dr. George transferred his home to a The Stepping Stone Land Trust in return for 100 "capital units" in the trust. Dr. George continued to live in the house and make mortgage payments; he did not make rent payments to the trust. Dr. George then formed The Arivada Medical Enterprises Trust, with his friend Chisum as trustee. In 1994, Dr. George assigned his 100 capital units in the first trust to the second trust. He continue to operate his medical practice in the same manner as before, but asked clinics and other third parties for whom he provided services to make payments to Arivada rather than to him directly. Although Chisum was the trustee, Dr. George had a trust checkbook and a signature stamp for Chisum. He paid personal and household expenses from the trust, but never paid rent to the trust for his use of the house. There were no employment agreements or lease agreements between the doctor and the trusts. Arivada filed fiduciary income tax returns as a simple trust and claimed that it had distributed its income to two entities, neither of which had a tax identification number. Dr. George reported a small amount of income from the trust. The Tax Court found that the trust arrangement was a sham, as Dr. George had retained all meaningful control over the trust. The result was deficiencies in Dr. George's Federal income taxes of $24,295 for 1993 and $27,893 for 1994, and accuracy-related penalties under section 6662(a) for negligence of $4,859 for 1993 and $5,578 for 1994. Even had Dr. George papered his trail better, it seems likely that the court would reach a similar conclusion. *Frank W. George v. Commissioner*, TC Memo. 1999-381; No. 20868-97, November 23, 1999.

Similarly, two recent sham business trust cases held that the taxpayers, and not their trusts, were taxable on trust income because the trusts, which were created to hold their farm assets, real, and personal property, lacked substance. One particularly interesting aspect of the Zachman cases is that "As part of the judgment against them, the promoters were ordered to supply the IRS with the names and addresses of all purchasers of the 186 business trusts on file with the State's Secretary of State which list them or their corporation as corporate trustees." So ultimately, the very people who sold these schemes became instrumental in their downfall. *Leon L. Zachman, et al.*, TC Memo 1999-392, 12/01/1999 ; *Allen O. Zachman, et ux.*, TC Memo 1999-391, 12/01/1999. Unfortunately, legitimate tax advisors are unlikely to come across taxpayers who have bought into these sham schemes until long after the fact; the Zachmans, for example, obtained their tax advice in their doctor's waiting room!

These cases remind us that the Service continues its pursuit of abusive trusts. Perhaps more important than getting clients to competent tax advisors is learning to recognize the

differences between the many legitimate uses of trusts and those that are clearly abusive. The key is economic substance. In other words, if you want a trust arrangement to be respected, it has to act like a trust. Among the questions to ask are these:

a. Did the taxpayer's relationship as grantor to the property change after the purported transfer into the trust?

b. Did the grantor's position vis a vis the property differ materially before and after the trust's formation?

c. Does the trust have a truly independent trustee?

d. Does an economic interest pass to other beneficiaries of the trust?

e. Did the taxpayer feel bound by any restrictions imposed by the trust or by the law of trusts?

Elaborate schemes involving off-shore trusts are often touted as providing tax savings, asset protection and effective business succession. These approaches should be subjected to the same analysis to determine whether they are substance or sham. Similarly, the "sham trust" line of cases provides us with guidance in the business arena. Business organizational and operational documents do little good unless they are observed in practice; then, and only then, will they have economic substance and then, and only then, will they have any effect on valuation of the business interests.

The Internal Revenue Service is waging a major campaign against trusts it has labeled as abusive. It has collaborated with the Justice Department to bring criminal charges against some purveyors of these schemes. Business owners should beware of fast talkers who sell expensive systems that sound too good to be true – they almost certainly are.

B. Waiting Too Long to Make a Gift – The Diet Center's Owners Lost More Weight Than They Intended. This year, the Ninth Circuit upheld the Tax Court's ruling in *Ferguson*, 108 TC 244 (1997). *Ferguson. v. Commissioner*, 174 F.3d 997 (9th Cir.1999). The Ferguson had owned, and continued to operate, the Diet Center, which had merged into AHC, a corporation in which the Fergusons held a minority interest. When AHC sought to be acquired by a third party, the Fergusons prepared to transfer some of their AHC shares to their favorite charities to avoid incurring capital gains taxes while securing a substantial charitable deduction. The key issue was whether the Fergusons had completed their contributions of the appreciated AHC stock before it had ripened from an interest in a viable corporation into a fixed right to receive cash. Events occurred in rapid sequence on the following dates:

July 28, 1988 - AHC approved merger agreement with the Fergusons' abstention. The plan was for the acquiring corporation to acquire

90% of the AHC stock by tender offer prior to completing the merger.

August 3, 1988	The tender offer began. The expiration date, originally earlier, was extended to September 9, 1988.
August 15, 21 & 23, 1988	The Fergusons' stock broker at Merrill Lynch assisted them in preparing a "donation-in-kind" record indicating their intent to contribute shares to their church and a private foundation not yet in existence as well as letters authorizing Merrill Lynch to transfer the shares to the charities. The letters presented to the Tax Court indicated that the date of the gift was September 9, 1988.
August 26, 1988	The private foundation was formed.
September 8, 1988	After completing a legal check of the legality of the transfer, Merrill Lynch completed the transfer of the shares to the charities' accounts, including a newly-established account for the foundation.
September 9, 1988	The Fergusons and the charities tendered their shares.
September 12, 1988	The acquirer announced its acceptance of the tender offer.
October 14, 1988	The merger was completed.

The Ninth Circuit upheld the Tax Court's finding that by August 31, 1988, when 50% of the stock had been tendered, the likelihood of the merger was sufficiently solid that the stock had "ripened" into a claim for money and that the transfers to the charities had not been completed at that time. The Fergusons were thus taxable on the capital gain realized on the sale of the shares by the charities.

In offering its analysis, the Court admonished the reading public that:

> Any tax lawyer worth his fees would not have recommended that a donor make a gift of appreciated stock this close to an ongoing tender offer and a pending merger, especially when they were negotiated and planned by the donor.

Ferguson is a helpful reminder of the dangers of cutting the time line too close when planning for a disposition of a business or other property. When clients hope to avoid taxation on

appreciated property through gifts to charities, to charitable trusts or to other family members, they must initiate the process long before the sale comes to fruition.

V. A WORD ABOUT ETHICS (PRIMARILY FOR ATTORNEYS)

A. Ethical Challenges in Representing Multiple Parties

Advising two or more people who own a business presents a variety of very tricky multiple-representation issues. The representation becomes even more sensitive in the family business context. With perhaps the exception of a family renegade or outcast, participants in a family-run business tend to look to the business's lawyer or accountant as the family counselor, in the finest tradition of an "attorney and counselor at law". When you are viewed as the family's counselor, you must be particularly careful to establish and document what your role is and who your client is. Unfortunately, the Model Rules of Ethics, which have generally been adopted in Colorado as the Colorado Rules of Professional Conduct ("Rules"), are not particularly friendly to the transactional, or "office" lawyer, especially in the family counseling arena. *See*, for example, *Developments Regarding the Professional Responsibility of the Estate Planning Lawyer: The Effect of the Model Rules of Professional Conduct*, 22 <u>Real Property Probate and Trust Journal</u>, 1 (Spring 1987); Pennell, *Ethics in Estate Planning and Fiduciary Administration: The Inadequacy of the Model Rules and the Model Code*, 45 The Record of the Association of the Bar of the City of New York 715 (October 1990); *Professional Responsibility: Reforms are Needed to Accommodate Estate Planning and Family Counseling*, 25 U. Miami Institute of Estate Planning ¶18-1 (1991); and *Commentaries on the Model Rules of Professional Conduct*, ACTEC Foundation 1995.

As Gerald LeVan, a frequent writer on the topic of family businesses, has observed:

> Here lawyers still seem to concern themselves too much with technicalities and too little with what is happening to clients and their families. The assumption is that with good documents and good tax planning, success of the next generation in the family business is assured.
>
> Two important steps should precede the commencement of traditional estate planning for a family business: (1) an in-depth assessment of family relationships and goals and (2) careful planning for management transition to the next generation.

LeVan, *Keeping the Family in the Business: Estate Planning May Not Be Enough,* 2 Prob & Prop 28 (Nov/Dec 1988).

When representing a family business, the advisor confronts two overlapping and often conflicting social structures, a family and a business, whose goals and dynamics do not necessarily mesh and may directly conflict. While the primary goal of a family is generally to nurture and protect the family members, that of a business is to make money.

Accommodating both these goals may require walking a thin and shaky tightrope; at times, it may be impossible. What, for example, should be done with Uncle Joe, whom the family wish to compensate at the same salary level as his siblings, but whose sales route seems to invariably end in a bar, rather than a customer's office? How much can we care for the needy family member without sacrificing the viability of the company that ensures its welfare? How far can we stretch the definition of reasonable, and thus deductible, compensation for income tax purposes? The potential conflicts intensify when the family involved in the business is a "blended" family, replete with children from prior marriages, perhaps a much younger child of a current marriage and an ex-spouse or two. Our overriding ethical obligation of competence (for lawyers, this edict is set forth in Rule 1.1) requires us to be a combination of counselor, mediator, management consultant, technician, psychologist and magician to address the disparate issues fully and appropriately. We are also constantly aware not only of our ethical obligations, but of the possibility of our being sued if we fail to perform a duty we are obligated to carry out. Although the violation of an ethical standard does not in and of itself constitute malpractice, courts will look to such a violation as some indication that a duty exists or has been breached.

B. Avoiding Conflicts of Interest

Rule 1.7 sets forth the general rule on conflicts of interest. It provides as follows:

> (a) A lawyer shall not represent a client if the representation of that client will be directly adverse to another client, unless:
>
> > (1) the lawyer reasonably believes the representation will not adversely affect the relationship with the other client; and
> >
> > (2) each client consents after consultation.
>
> (b) A lawyer shall not represent a client if the representation of that client may be materially limited by the lawyer's responsibilities to another client or to a third person, or by the lawyer's own interests, unless:
>
> > (1) the lawyer reasonably believes the representation will not be adversely affected; and
> >
> > (2) the client consents after consultation. When representation of multiple clients in a single matter is undertaken, the consultation shall include explanation of the implications of the common representation and the advantages and risks involved.

(c) For the purposes of this Rule, a client's consent cannot be validly obtained in those instances in which a disinterested lawyer would conclude that the client should not agree to the representation under the circumstances of the particular situation

Rule 1.8 further provides a laundry list of "prohibited transactions" and those which may only be undertaken with written disclosure and consent. As a general rule, the message conveyed by the Rules is that representation of more than one client should be undertaken only with full disclosure, in writing, preferably accompanied by a signed waiver. But what constitutes full disclosure? The full extent of the potential conflict among the parties is not generally known at the outset of representation. It may be impossible to determine whether a course of action that encompasses retirement planning, business entity formation and family wealth transfer will result in antagonism and conflicts. Yet without adequate disclosure (always determined after-the-fact), it may be impossible to obtain an informed consent.

It is common for attorneys to advise both husband and wife concerning their estate planning goals. Much has been written elsewhere concerning the degree of disclosure and waiver necessary in order for the attorney to fulfill his or her ethical obligation to both parties. *See*, for example, *Comments and Recommendation on the Lawyer's Duties in Representing Husband and Wife*, 28 Real Property, Probate and Trust Journal, 765 (1994). The conflict, and thus the need for independent counsel, becomes more apparent, and sometimes not waivable, when representation expands to include the business operated by one or both of the spouses and perhaps a child, aunt, uncle or cousin or two. Written disclosure of the potential conflicts among the parties and the extent of the representation, is essential; such disclosure clarifies the attorney's role, helps to ensure compliance with ethical standards and provides useful documentation in the event of a malpractice claim involving the attorney's duties to the various parties involved.

When representing multiple clients, the time may come when a relationship which seemed at first to be benign turns adverse. Recognizing the moment when the tide has turned may not be easy. Once the moment is recognized, the lawyer's course of action is clear; she has no choice but to withdraw.

At first blush, Rule 2.2 seems to offer an attractive alternative. It permits an attorney to represent more than one client in the organization, operation or dissolution of a partnership as an "intermediary". The Comments to the Model Rules contemplated "arranging a property distribution in settlement of an estate" as an example of an appropriate use of the Rule. However, Rule 2.2 imposes significant limitations on the representation of any of the clients. The attorney should make very clear the scope of the representation in this circumstance. Because the attorney has a duty to each of the clients, there is probably no attorney-client privilege as among the clients. Hence, it must be assumed that if litigation or other dispute arises between any clients, the privilege will not attach to any such communications.

Choosing to act as "intermediary", rather than as the attorney for one or more of the multiple clients may, as stated in the commentary to the Rule result in "additional cost, embarrassment, and recrimination", precisely the opposite of clients' usual intent in these situations. Clearly such representation must be approached with care and trepidation and never at a time when differences have already emerged. The clients must also be advised that if they are not able to resolve any differences among themselves, the attorney will in all probability be required to withdraw from representing any of them. The attorney must likewise withdraw upon the request of any member of the group for whom he or she is acting as an intermediary, thus causing further delay, expense and conflict. Rule 2.2 is thus unlikely to provide a satisfactory solution to the multiple representation conundrum. *See* Dzienkowski, *Lawyers as Intermediaries: The Representation of Multiple Clients in the Modern Legal Profession*, U. Ill. L. Rev. 741 (1992).

Even where the attorney has made it clear that her representation is limited to the senior generation, she must still be concerned about her potential liability to her client's descendants and business associates. What is an attorney's duty to non-clients who may be intended beneficiaries of a business succession plan? In Colorado, at any rate, attorneys are not generally found to owe a duty to non-clients, short of deliberately fraudulent or malicious acts. *Weigel v. Hardesty*, 37 Colo.App. 541, 549 P.2d 1335 (Attorney for wife in divorce not liable to husband for releasing deed from husband to wife without obtaining a lien to protect husband. "While fulfilling this obligation to his client, he is liable for injuries to third parties only when his conduct is fraudulent or malicious."); *Berger v Dixon & Snow, P.C.*, 868 P.2d 1149 (Colo.App. 1993). *Hill v. Boatright*, 890 P.2d 180 (Colo.App. 1995), modified 20 Brief Times Reporter 975 (Colo. 1996). This rule has been applied to hold that an attorney who drafted estate planning documents is not liable to beneficiaries. *Shriners Hospital for Crippled Children, Inc. v. Southard*, 892 P.2d 417 (Colo.App. 1994). Similarly, Colorado courts have held that an attorney's liability to third parties should be limited because of the attorney's duty of loyalty and effective advocacy to his or her client, the nature of the potential for adversarial relationships between the attorney and other parties, and because of the attorney's unlimited potential liability if attorney liability is extended to third parties. *Schmidt v. Frankewich*, 819 P.2d 1074 (Colo.App. 1991). *But see, Central Bank Denver v. Mehaffy, Rider, Windholz & Wilson*, 865 P.2d 862 (Colo.App. 1993), a case brought by a non-client recipient of an opinion letter at a loan closing. When the non-client is viewed as a co-owner of a business, as opposed to a beneficiary of an estate, it is highly unlikely that the attorney for the majority business owner would be considered to have any duty toward the co-owner in the absence of a family relationship. The existence of a family relationship among co-owners should not, therefore, increase the attorney's liability, provided that the attorney has avoided being considered the co-owner's attorney by virtue of his status as the company or family lawyer. *See Felty v. Hartweg*, 169 Ill.App. 3d 406, 119 Ill. Dec. 799, 523 N.E.2d 555 (1988), which discusses the duties owed by an attorney for a closely held corporation to a minority shareholder. In egregious circumstances, however, the attorney-client privilege may not be available, and a duty owed to a minority shareholder under the "crime-fraud exception", which is implicit in the prohibition of Rule 4.1 on a lawyer's making false or misleading statements to third parties or failing "to disclose a material fact when disclosure is necessary

to avoid assisting a criminal or fraudulent act by a client". *See Garner v. Wolfinbarger*, 430 F.2d 1093 (5th Cir. 1970); *Montano v. Land Title Guarantee Co.*, 778 P.2d 328 (Colo.App. 1989).

It is yet to be seen whether the influential drafters of the Restatements will have an impact on Colorado law. Section 73 of the proposed *Restatement (Third) of the Law Governing Lawyers* provides that

> a lawyer owes a duty to use care …
>
> (2) to a non-client when and to the extent that the lawyer or (with the lawyer's acquiescence) the lawyer's client invites the non-client to rely on the lawyer's opinion or legal services, the non-client so relies, and the non-client is not, under applicable law, too remote from the lawyer to be entitled to protection;
>
> (3) to a non-client when and to the extent that the lawyer knows that a client intends the lawyer's services to benefit the non-client, and such a duty substantially furthers fulfillment of the lawyer's obligations to the client and would not significantly impair the lawyer's performance of those obligations.

Broader than current Colorado law and in direct conflict with *Southard*, the Restatement probably reflects the current trend in the law nationally. *See, e.g., Bucquet v. Livingston*, 57 Cal. App. 914, 129 Cal. Rptr. 514 (1976), holding that an attorney whose improper drafting of a revocable living trust led to a significant tax liability was liable to the trust beneficiary based on the clear intent of the transaction to affect the beneficiary, the foreseeability of harm to her, the degree of certainty that she suffered injury, the closeness of the connection between the attorney's conduct and the injury, the moral blame attached to his conduct, and the policy of preventing future harm. Once again, the message seems to be to clarify, ideally in writing, your client's intent to determine the nature and extent of your own obligation, both to your client and others.

C. Confidentiality

Central to the attorney-client relationship is the sacred obligation to maintain confidentiality. In Colorado, the CPA-client relationship is also privileged. C.R.S. § 13-90-107(1)(f). Since 1998, a limited accountant-client privilege exists for federal income tax purposes as well. The conflicts of interest rules are intended in part to ensure that the privilege is preserved. The written disclosures and consents recommended when representing multiple parties will permit a lawyer to disclose information confided to him by one client to the other, if necessary and appropriate to the representation.

Rule 1.6 memorializes the attorney's obligation to maintain confidentiality. It provides as follows:

Rule 1.6. Confidentiality of Information

(a) A lawyer shall not reveal information relating to representation of a client unless the client consents after consultation, except for disclosures that are impliedly authorized in order to carry out the representation, and except as stated in paragraphs (b) and (c).

(b) A lawyer may reveal the intention of the lawyer's client to commit a crime and the information necessary to prevent the crime.

(c) A lawyer may reveal such information to the extent the lawyer reasonably believes necessary to establish a claim or defense on behalf of the lawyer in a controversy between the lawyer and the client, to establish a defense to a criminal charge or civil claim against the lawyer based upon conduct in which the client was involved, or to respond to allegations in any proceedings concerning the lawyer's representation of the client.

(d) A lawyer shall exercise reasonable care to prevent the lawyer's employees, associates, and others whose services are utilized by the lawyer from disclosing or using such information, except that a lawyer may reveal the information allowed by paragraphs (b) and (c) through such persons.

Straightforward though it may appear, the language of the Rule provides little assistance to the attorney who represents both a business and its owner or even several or future owners.

Many estate planners, and I count myself among them, encourage their clients to share their business and estate planning goals with their family members. While some of our clients may entertain the thought of chuckling from the grave when their shocked families discover at the proverbial (and for the most part mythical) reading of the will that the loyal secretary, and not the family, will inherit the family business, most of them wish their family members and business associates to be fully prepared for future transitions. To be prepared, they must be informed, and that means including them in the planning stages. At that point, the duty of confidentiality, as well as the extent to which the attorney-client privilege might be waived, becomes murky indeed. If your client is the business and its owner, the family matriarch, disclosure of the owner’s plans to the next generation must, first and most important, be permitted by the owner. If disclosure has been authorized, has the privilege been lost, rendering your confidential planning letters discoverable by business associates or (horror of horrors!) the IRS? To create an appropriate and comprehensive business succession plan, free and open communication within the affected group is essential. To avoid the inadvertent disclosure of information to the outside world, the attorney would be well advised to create a disclosure document that states that all the members of the group are his or her clients and that the duty of confidentiality extends to all of them. Further, it should state that the attorney may disclose information or aspirations and plans communicated by one member of the group to another member (a co-client) if the disclosure is material to the representation of the group.

Such disclosures have become routine in the representation of all the owners of a business or of both husband and wife in the estate planning context. When both aspects, and multiple generations, are involved, the disclosure and waiver document must be artfully drafted to preserve the attorney-client privilege *vis a vis* third parties, while limiting the scope of representation of some members of the group. For example, when a family meets to discuss the best method of passing on the family business to one, but not all, members of the next generation, sharp differences of opinion and outright conflicts may arise. The umbrella of representation should be broad enough to preserve confidentiality, but not so broad that the attorney owes undivided loyalty to all members of the group. For example, it may be possible to limit representation of the next generation to tax planning advice while maintaining loyalty exclusively to the older generation with respect to other aspects of the overall family business succession plan.

As the trend towards multidisciplinary practices continues, we must be eternally aware of the ethical perils that may lurk behind the trees of this new forest we are entering.