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Turning visions into legacies

Succession planning strategies for the privately-owned business

It takes a family to employ a nation

Family owned businesses are central to the U.S. economy, contributing 64% of the U.S. gross domestic product, employing 62% of the workforce and creating 78% of all new jobs.[1]

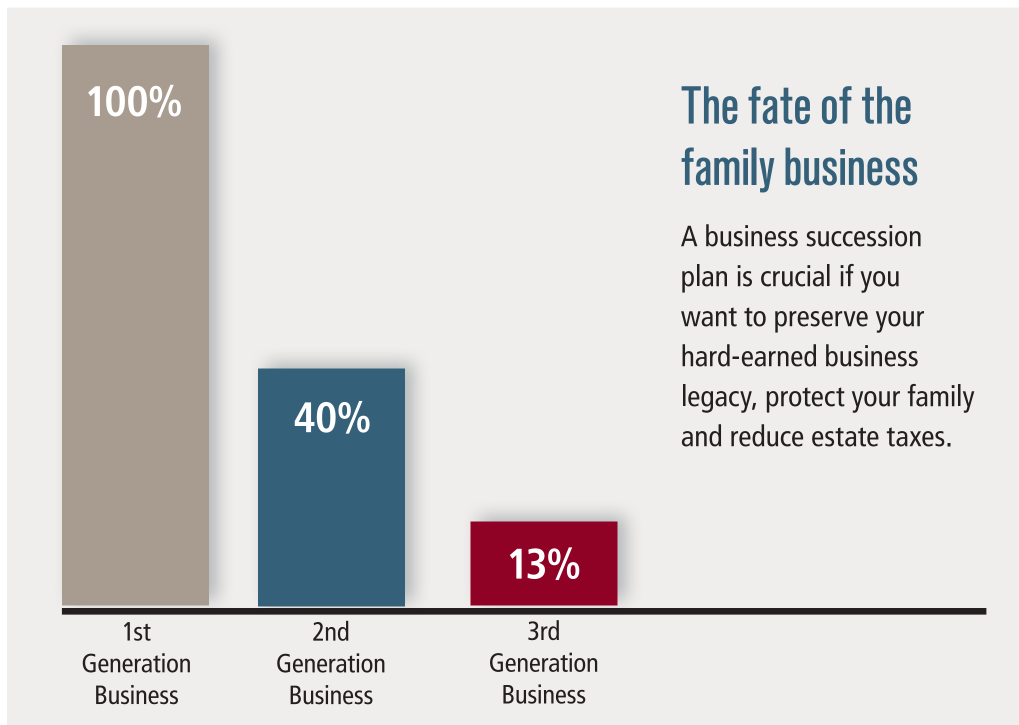
Yet only 40% of these businesses survive into the second generation, and only 13% will still be around by the third.[2]

Why are business survival rates so low?

Two obvious reasons are family conflict and federal estate taxes. But a third reason is perhaps even more influential: failure to design a proper succession plan.

Business owners are typically so busy with day-to-day challenges that they often have little time to think about who will take over the business once they're gone. But the consequences of having no plan in place could be catastrophic to the family, employees and others who depend upon the business. For instance:

- Will the business have to be sold in order to pay estate taxes?
- If a co-owner dies, will there be a conflict between the surviving business owners and the co-owner's family?
- Will the children of the owner wish to continue the business? What if they don't?



[1] "Family Business Facts," Conway Center for Family Business, www.FamilyBusinessCenter.com, cited 2/29/16.

[2] "Facts About Family Business," Center for Family Business, www.business.fullerton.edu, cited 2/29/16.

Beat the statistics

What a succession plan can do for you

At its most basic, a succession plan is a documented road map for your partners, heirs and successors to follow in the event of your death, disability or retirement. It can also be used to orchestrate the sale of your business and may even help establish the value of your business. It may also help:

- Establish who would run the business if you retire or pass away
- Set policies for distribution of business stock and other assets
- Set schedules for debt retirement
- Encourage key employee retention
- Protect the business should a partner decide to take his share and leave
- Prevent family conflict from forcing the sale of the business
- Pay estate taxes without sacrificing the business
- Provide a way to take advantage of unexpected expansion opportunities

In addition, having a sound succession plan may help you as you seek to secure your own retirement!

Less than 30% of business owners have a written succession plan.[3]

[3] "Small Biz Owners Ignoring Succession Advice: Poll," article discussing FPA/CNBC Business Owner Succession Planning Survey, April 13, 2015, www.cnbc.com/2015/04/13/ew-small-biz-have-an-exit-plan.html.

How do you begin?

Establish your objectives

Clearly establish your objectives – what you want the plan to accomplish.

Communicate your plan

Communicate your vision with your family, business partners and key employees. Honest and ongoing communication is essential to preventing surprises and helping to manage conflicts that could disrupt your business. The key is to resolve them early on to preserve your family and the ongoing success of your business.

Be flexible

Your plan should be flexible, since business, family and health situations can change at any moment. Make sure that, regardless of what may arise, your business is structured to handle unexpected changes and opportunities. Create "what if" scenarios with those who are important to the business, including qualified legal and financial professionals.

Choosing a successor

Is there really anyone out there who can run your business with the unparalleled style and acumen that you've brought to it? Well, unless you're there to show them how, there won't be.

So decide who is best qualified and start grooming that person today. This step may be easier said than done. You may have a choice of equally qualified children or employees. If more than one child is involved in the business, you'll need to decide who gets to be boss and who gets voting stock.

If no likely candidates come to mind, you may want to examine your hiring and training programs, or even your own management style, to see if they're keeping employees from becoming leadership material.

The secret is to make your decisions in a way that will allow your business to survive, your employees to stay happy and ideally, your family to remain at peace.

It's difficult for any business owner to let go. But getting the next generation ready to lead is one of the most critical ways to protect your company's future. Once you've done that, you're ready for the financial aspect.

It takes holistic solutions to create a solid succession plan

Here are several solutions that you and your legal or financial advisor may want to consider when creating your business succession plan.

Estate and gift taxes

The federal estate and gift tax rates are unified and apply graduated rates on amounts transferred during life or at death, beginning at 18% and increasing to 40%. The federal estate and gift tax exemption for gifts made by, and estates of, decedents dying in 2016 is $5,450,000 (as adjusted for inflation). The federal estate and gift tax rate for transfers made by, and estates of, decedents dying in 2016 is a flat 40% on transfers in excess of the $5,450,000 credit amount of $2,125,800.

The transfer tax system

Generally speaking, transfers of property are taxed based upon the fair market value of the property at the time of the transfer. With a few exceptions and exemptions, the lifetime transfers are combined with those occurring at death, and are subject to the graduated rates discussed above.

Key exceptions include:

- **Annual gift tax exclusion.** In 2016, every individual can transfer, free of gift tax, up to $14,000 per year, per donee. There is no limit to the number of donees. To qualify, the gift must be considered a “present interest.”
- **Credit.** Each individual is allowed an estate and gift tax credit. For 2016, the amount can be up to $2,125,800. This credit allows an individual to make tax-free transfers of up to $5.45 million during lifetime or at death for 2016.
- **Marital deduction.** Transfers between spouses do not incur transfer taxes, as long as each spouse is a U.S. citizen. The use of the marital deduction does not eliminate transfer taxation, but simply defers it. For non-U.S. citizens, a special trust is required to defer transfer taxation.
- **Charitable deduction.** Techniques are available to combine the tax advantages of charitable giving with the natural desire to provide for family members.
- **Life insurance.** If a person gives away a life insurance policy on his or her life, they must live for three years after the transfer. Otherwise, the policy’s entire death benefit is includible in the donor insured’s gross estate.

Generation-skipping tax

The transfer tax system imposes a tax on assets at each generation, such as those passing from parent to child.

The generation-skipping tax hits those transactions that are designed to skip a generation. For example, a grandparent is entitled to an exemption from this tax of up to $5.45 million in 2016. This exemption amount matches the estate tax exemption.

However, the tax rules for these transactions are complex. Poor planning can cause the amount of the tax to exceed the value of the asset that was transferred.

Business valuation

The IRS may believe that your business value is higher than you anticipated. You, on the other hand, want to have the value lower to reduce estate taxes.

If the IRS wins, your future heirs could be forced to sell all or a portion of your business in order to meet their tax obligations. You may be able to prevent or reduce the potential for dispute by including a bona fide business valuation in your succession plan.

"Fair market value" is usually defined as the amount a willing buyer would pay to a willing seller with neither being under any compulsion to conclude the transaction. A qualified, independent appraiser can be a valuable ally, both to help you set value and work with you should a dispute arise with the IRS.

Once the fair market value of your business has been established, discounting methods may be applicable during ownership transfer. These discounts may help lower the business valuation at the time of transfer and reduce taxes in the process. The most common discounts are:

- **Lack of marketability discount.** When a buyer or successor cannot be expected to pay the full market value of your shares due to the lack of a readily accessible market for a future sale of those shares.
- **Minority discount.** Shareholders with less than 50% ownership lack majority control. This could lower the value of the shares to your future heirs or an outside buyer, which could reduce the asset value subject to transfer taxes.

Tax-reduction strategies

These brief descriptions are meant to provide you with an overview of potential business succession strategies. Naturally, they cannot offer you sufficient information for you to make a choice. A qualified business succession professional can help you determine which, if any, of these strategies could be right for you.

Buy-sell agreements

These are contracts between two or more business owners, which outline the terms of ownership transfer if an owner retires, becomes disabled or dies. They are most often structured as entity redemption, cross purchase or "wait and see" agreements.

One of the major problems with buy-sell arrangements is finding the funds for either the owners or the business to buy the deceased owner's business interest. Life insurance can often be the source for these funds. Of course, the insurance death benefits must be reviewed periodically to determine if additional insurance is needed as the value of the business increases.

Entity redemption
This type of buy-sell agreement occurs when the business buys back an equity interest from a business owner or a deceased business owner's estate. Typically, the estate receives cash in exchange for the equity interest.

Cross purchase
This type of buy-sell agreement calls for the remaining business owner(s) to buy the equity interest of the departing or deceased business owner. To fund such a plan at death, owners typically buy life insurance policies on each other. The surviving business owner (not the entity) purchases the equity interest from the decedent's estate.

"Wait and See"
This is a hybrid buy-sell strategy designed to provide flexibility at the moment it's needed: at the death of the business owner.

In general the business entity has the first option to buy the decedent's business interest. If an equity redemption plan seems best, that is the option the business will choose, and the estate will be obligated to sell under a binding agreement.

If a cross purchase appears preferable, the business will allow its option to lapse. The surviving owner(s) will then have the option to purchase the business interest.

If neither option is chosen, the business entity would be required to purchase any remaining business interest. This guarantees that the full value of the business is received by the decedent's family.

Provisions should address the following as triggering events: death, disability, divorce, bankruptcy, termination, retirement and, in a professional corporation, loss of a professional license.

Gifts of business interest

Making a lifetime gift is often an effective way to reduce estate taxation. Depending on economic ability, you may be more or less willing to make a significant lifetime transfer of wealth. By modeling the asset base and cash flow requirements before making these gifts, you may discover whether or not you can afford to give up control of the assets.

Gifts can be made outright or in trusts. The benefits can include:

- Shifting an asset's income and growth out of a higher income tax bracket
- Shifting out of a high estate tax bracket
- Gaining tax leverage (even though estate and gift tax rates are the same, the way they're calculated favors lifetime transfers, as shown in the tax transfer system chart)
- Allows a "testing ground" for future management skills.

The tax transfer system

Comparison of gift and estate taxes. Total value of assets = $6,000,000			
Gift tax*		**Estate tax***	
Tax base: net value of assets transferred	$4,000,000	Tax base: total value of assets available	$6,000,000
Gift tax: tax rate x tax base	$2,000,000	Estate tax: tax rate x tax base	$3,000,000
Net transfer to donee: total assets – tax	$4,000,000	Net transfer to heirs: total assets – tax	$3,000,000

*Assume gift/estate tax rate of 50%. Highest marginal rate in 2016 is 40%.

Life insurance

The use of life insurance may be a practical planning tool. This is because premiums are priced relative to policy proceeds.

For a married couple, it is common to use second-to-die coverage to handle estate liquidity needs. However, if the person who is insured owns the policy, the proceeds are subject to estate tax. Therefore, life insurance should be owned outside of the estate in order to avoid inclusion of the proceeds and corresponding taxes. One strategy is to place life insurance in an irrevocable trust or in ownership by adult children.

Life insurance is also typically used to fund buy-sell agreements. In an entity redemption, the entity owns a policy on the life of each business owner. In a cross purchase, each business owner owns a policy on the life of each of the other owners.

Private annuities

A private annuity may be used in family situations, where a parent wants to transfer an asset, such as a business interest, to the next generation free of estate taxes.

Typically, the parent sells the asset to the child. In return, the child promises to pay the parent an income for life. This is a legally enforceable contract right, but it's unsecured. Since the payments to the parent terminate at death, the annuity generally has no value and therefore is not included in the parent's estate.

To be successful, the present value of the annuity payments has to be equal to the fair market value of the asset being sold. The child takes the risk that the parent will live beyond life expectancy, and the parent takes the risk that the child will not meet the current payment schedule. It should be noted that income taxes may be due at the inception of the transaction.

Self-cancelling installment notes (SCIN)

A SCIN is, like a private annuity, an installment purchase of a business usually by the owner's child. Unlike a private annuity, however, the terms of a SCIN should be shorter than the parent's actuarial life expectancy. The SCIN is cancelled, and no further payments are due, if the seller dies before payments are completed. The SCIN installment payment includes a higher interest rate as a "risk premium." Generally, nothing will be included in the seller's gross estate, but any deferred gain on the installment obligation will be reported for income tax purposes.

Family partnerships/Limited Liability Companies (LLCs)

A family partnership or LLC can help shift both the income tax burden and asset appreciation from parents to children or other family members. However, the benefit of shifting income to children younger than age 24 may be limited, because such income can be taxed at the parents' income tax rate.

It is also possible to transfer business interests to children and retain control by maintaining the general partnership/LLC interest. Additionally, it is possible to receive a discount for gift tax valuation purposes if the transferred partnership/LLC interest is a minority interest. Discounts can also apply due to the lack of marketability of partnerships/LLCs. Any appreciation on transferred interest should not be included in the transferor's estate, assuming a valid partnership/LLC has been established.

Management control

A business owner may wish to give, bequeath or sell the equity in a business to family members even though the owner is not confident that the new owner will be competent to run the business. There are a number of ways to manage this situation.

A case for succession planning

Situation

Two brothers, 50-year-old Dan and 45-year-old Brad, co-founded an electronic supply company with three locations. Both men are married with wives who work in the company, and each brother has a son who works for the company.

Dan's son is older than Brad's and has been working full-time for the company for a number of years. Dan also has a daughter who is not employed by the business. Brad's son is finishing high school and works part-time.

Dan's net worth is $12.5 million, while Brad's is $11 million. Almost all of each family's assets are owned in the brothers' names, with each wife owning only a small percentage of the assets (roughly 10%-20% each). Dan recently finished updating estate planning documents, but Brad's documents were out of date and exposed to estate taxes.

Concerns

- The current buy-sell agreement is funded with life insurance, but mandates that the deceased owner's family be bought out with the insurance proceeds.
- Under the current design, the deceased's family is made to relinquish emotional and financial interest in the company the deceased worked so hard to build.
- Since the business, under present circumstances, is a successful concern, the deceased brother's family has no right to share in future appreciation of assets.
- Since spouses and sons are also employees of the business, they could each potentially lose all management power bestowed by voting rights and in the case of one brother predeceasing the other, the members of the deceased brother's family could potentially face job loss if relations become acrimonious.
- All personal life insurance is owned in the estate of each insured, while the buy-sell coverage is cross-owned (i.e., each brother owns the other's policy).

Potential Solutions

- Determine what the families really want to happen with the business in the event that one partner predeceases the other. Be cognizant of the fact that Dan is five years older than Brad and would likely pass away or retire before his brother.
- Move all personal insurance ownership out of the estate of each family member (spouses included).
- Transfer the buy-sell insurance to an irrevocable trust so that the proceeds would be kept for the benefit of the deceased brother's family. This would allow retention of the stock and ensure strong financial backing for said family.
- Implement a stock gifting strategy as a means to reduce the estate of the brothers, while also rewarding the sons who participated in the business.
- Update Brad's estate planning documents to reflect the new business transfer strategy and coordinate with various trusts.

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