Lifecycle of a Family Business Owner
The Retirement Years

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Business Succession

- Two types of succession planning:
  - Management Succession
  - Ownership Succession

Management Succession

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- Questions to Answer:
  - Should Family continue to control?
  - How will management decisions be carried out if family control is desired?
  - Should outside board members be hired now?
  - How long should transition occur?

Management Succession

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- How to address multiple families and continued management by successor generation:
  - **No handouts – every one must be qualified for position**
  - **Compensation Boards of Family and Non-Family Members**
  - **Outside Members of Board of Directors**

Implementation of Management Succession

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- After critical decisions on family versus non-family officers are determined, then implementation must be carefully structured.
  - **Require family members to have outside education and/or experience**
  - **Senior generation should stay involved and slowly shift control.**

Ownership Succession

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- Viewing management succession separately from ownership succession allows for more creativity in addressing both.
- Handling family members who are owners and officers

Ownership Succession

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- Recapitalizing Company into Voting and Non-Voting Shares
- Estate Freezes for Setting Equalization Formulas
- Spin-Offs for Separate Business Lines
- Charitable Planning

Implementation of Ownership Succession

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- Using the following techniques can result in an ownership succession plan that minimizes both gift and estate taxation:
  - GRATs
  - Sales to Defective Grantor Trusts
  - Charity Lead and Remainder Trusts
  - Preferred/Common Freeze Transactions
  - Annual Exclusion Gifting

SUCCESSION PLANNING

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1. INTRODUCTION

(a) Studies focusing on family owned businesses indicate that only 30% of these businesses make the transition from the first generation to the second. Of that 30%, only half make it to the third generation. [1/]

(i) Most people conclude that this is unfortunate because of the virtues traditionally associated with a family business - like keeping the family together, providing jobs for family members, etc.

(ii) Consider the notion that not all (or maybe even - not most) family business are intended to stay in a family from generation to generation.

(A) That may sound like heresy to some, but is it?

(B) Some younger generation family members don't have the interest, management skills or entrepreneurial spirit which is necessary for a business to thrive.

(C) The sibling rivalry and intra-family feuding a family business can engender may outweigh the benefits of keeping a business in a family.

1/ M. F. R. Kets de Vries, "The Dynamics of Family Controlled Firms: The Good News and the Bad News," *Organizational Dynamics*, 1993, pp. 59-71; and J. I. Ward, *Keeping the Family Business Healthy*, Jossey-Bass, San Francisco, 1987. See Chart Attached as Exhibit 1.

- Just ask someone who has been through an intra-family lawsuit regarding a family business. It can have a devastating effect on family members as well as the business enterprise.

- Intra-family litigation tends to bring out the worst in people, including cruel attacks on the very people the patriarch was looking to protect and provide for.

(D) Small family businesses may inhibit the ability of exceptionally talented family members to realize their full potential.

(E) Selling or going public is not necessarily a bad thing.

(F) It becomes more complicated where two separate families are co-owners of a small business. In addition to the intra-family issues, the owners also have to address issues regarding when one of the senior generation members dies. It is generally not intended that the surviving senior generation member would have to share decision-making responsibility with the decedent co-owner's spouse or family members; however, the economics of the situation usually do call for that.

(b) Accordingly, a business owner needs to honestly assess the situation to determine whether his/her family and the business will be well served by making the generational transition or whether the family and business will be better served by utilizing senior management or third parties in either ownership and/or management positions. Regardless of the decision of whether to retain the business in the family or to sell the business to senior management or even third parties, the owner needs to:

(i) Develop and implement a management succession plan; and

(ii) Develop and implement an ownership succession plan.

2. DEVELOPING AND IMPLEMENTING A GENERATIONAL TRANSITION PLAN

(a) It is important that the planning and implementation processes begin before a crisis (e.g., the death, disability or retirement of the owner/manager) develops.

(b) Many business owners are reluctant to start creating a generational transition plan because it forces them to address issues which they believe are better left below the surface.

(c) However, having no structured plan in place is still a plan that can be very destructive to the continued vitality of the business and can be costly as family members fight to determine who will control the business, usually leaving little say in the effort to senior management.

(d) Specifically, formulating a generational transition plan requires business owners, their families and key employees to address issues involving:

(i) mortality;

(ii) equality amongst family members;

(iii) liquidity of the business enterprise;

(iv) income for the retiring generation - including buying out that person's ownership interests;

(v) selecting the best successors;

(vi) resolving issues related to the ultimate ownership and control of the business; and

(vii) dealing with the human emotions attendant to all of the above;

(viii) the place for charitable intentions.

(e) There are four stages attendant to effective generational transition planning:

(i) Developing a management succession plan;

(ii) Implementing the management succession plan;

(iii) Developing an ownership succession plan; and

(iv) Implementing the ownership succession plan.

3. DEVELOP A PLAN FOR MANAGEMENT SUCCESSION

(a) The first step toward developing a generational transition plan is to work through the management succession issues.

(i) Ownership issues are secondary (despite what many tax advisors will tell you).

(ii) Indeed, recent studies [1/] suggest that the reasons families cannot keep a business in the family from one generation to the next are as follows:

[2/] M.H. Morris, R.W. Williams and R.A. Avila, "Correlates of Success in Family Business Transitions," *Journal of Business Venturing*, 1997, p.7.

• Inability of family members to get along with one another.	60%
• Lack of management skills in the next generation.	25%
• Estate taxes (i.e., failure to effectively implement an ownership succession plan).	10%
TOTAL	**100%**

(iii) Accordingly, while management succession may cause more emotional upheaval than ownership succession, if the business is to continue, then all involved must make a concerted effort to lay personal feelings and biases aside and work for the common good of the business.

(b) There are a number of issues which must be addressed as a part of the development of a plan for management succession:

(i) Will the business continue to be managed by the family?

(A) Depending on the abilities versus the limitations of family members, it may be better for the business to be sold to outsiders (where management transitioning is not as problematic from the seller's viewpoint) or to have management taken over by non-family members from inside or outside the business.

(B) If the decision is to keep management of the business in the family, a determination has to be made as to who will run the business.

(C) Some business owners want to avoid offending the feelings of their children who are active in the business by passing over one child for another.

- This can be a formula for disaster.

- Co-presidents and management committees are seldom the optimal way to run a business.

(ii) If the decision is to keep management of the business in the family, then the older generation must groom the successor.

(A) This can take years and requires effort on the part of both the older and younger generations.

(B) The transition is unlikely to work if the successors simply appear on the scene and start running the business.

(C) That can cause resentment among faithful employees and may result in the failure of the business.

(D) Instead, successors should be brought into the company early, learn the industry and develop professional relationships with employees, customers and suppliers.

(E) It is also recommended that the chosen successors have spent some time working outside of the company.

- This allows the successors to gain a perspective otherwise unattainable.

- Furthermore, it will give the successor an opportunity to learn the dynamics of managing a business without interference from an older generation.

- After gaining experience outside the company, the successor can come in as a manager or in another position with set responsibilities and periodic reviews.

(F) The advantages of this type of succession planning is that the successor learns the "ins and outs" of the business and it also gives the successor the time needed to develop solid relationships with employees, customers and suppliers.

(iii) If the decision is to leave the family with some economic interest in the business but transfer management of the business to senior managers or third parties, then the older generation needs to effectively bifurcate the business so that control and economic ownership are not tied together. This can be done in a number of ways, including:

(A) Buy/Sell Arrangements with Cross Purchase Obligations.

(B) Voting and Non-Voting Stock Recapitalizations where economic value is placed into the non-voting stock while control is maintained in the voting stock.

(C) Life insurance on business owners to fund obligations without impacting business operations.

(iv) Business owners who have spent their lives building a profitable business are often reluctant to turn over the reigns to the incoming managers.

(A) However, if the transitioning process is going to work, and the business is going to continue to grow, then the owner who is stepping down must accept a modified role in the company.

(B) In some situations, the business owner may completely divest himself of any active role in the company's day to day management while still retaining an ownership interest and/or voting control of the business for a time.

4. IMPLEMENT THE MANAGEMENT SUCCESSION PLAN. In order to effectuate the management succession plan, there has to be a concerted effort by the business to make the change in management as seamless as possible. This process takes time and often involves the following considerations:

(a) Having selected a successor, careful attention needs to be given to how that decision will be communicated to the company's employees, customers and suppliers.

(i) As noted above, if the successor is a family member who has not been active in the company, some experts question whether that person should immediately be given the manager's position, versus placing him/her in some lower level position intended to serve as a proving ground for the new manager.

(ii) Others suggest the successor should immediately be placed in a management position to test his/her abilities.

(iii) Ultimately, this issue tends to get resolved based on how prepared the successor is for the job and the amount of time available for on-the-job training/grooming.

(b) An important part of the transition process is to provide the successor with outside education on managing a closely-held business.

(i) Seminars and training programs will expose the successor to different opportunities and allow him/her to determine whether other methods of management may be useful at the business.

(ii) It also allows the successor to interact with other business owners and develop a network of professionals who are facing similar issues.

(c) As the successor becomes more comfortable in the business, the older generation should slowly divest itself of control by progressively handing over responsibility for the day-to-day operations to his/her successor. However, at the same time, the older generation often retains ultimate decision-making capacity.

(i) As the older generation develops confidence in the successor, the older generation should begin collaborating with the successor on major decisions affecting the business, allowing the successor's input to have sufficient weight.

(ii) When the orientation process has run its course, control over the day to day affairs of the business should be transferred to the successor.

5. DEVELOP A PLAN FOR OWNERSHIP SUCCESSION. Once the concerns over who is going to run the business have been resolved, the owner can start planning for the transfer of the ownership of the business.

(a) This stage allows for much creativity and if done properly can result in significant estate and gift tax savings.

(i) This is the area where your tax advisors and planners are most helpful.

(ii) There are a number of techniques (and variations thereof) which afford the business owner complete flexibility and control as to the ultimate ownership of the company while at the same time significantly reducing the transfer tax cost of effecting such techniques.

(b) Most business owners want to achieve some sense of equality among their children with respect to the ownership of the business, while at the same time recognizing the contribution being made by the person who was chosen as the management successor. This tension is the source of constant struggle for some business owners and their families.

(c) Set forth below is a brief description of <u>some</u> of the strategies available to the business owner to transfer the business to whomever he/she desires on a tax efficient basis.

(d) Lifetime gifting is one of the most powerful transfer mechanisms available, and is also the simplest.

(i) Currently the Internal Revenue Code permits tax free gifts of up to $12,000 ***per year per donee*** (or up to $24,000 if the donor is married and the spouse agrees to splitting the gift).

(ii) As a result, a married business owner with three children can give $24,000 worth of the business to each of his/her children (or $72,000 in total) each year, without incurring any transfer tax consequences. The effect of the gifting is two-fold.

(A) It reduces the business owner's taxable estate by the value of the gift; and

(B) Any appreciation on the gifted stock is excluded from the business owners estate.

(iii) Also, since the interest being given to each person is a minority interest in a non-marketable security, it is likely that a discount of 30-50% would be applied to the interest being transferred.

(iv) This technique works well for business owners who have substantial other assets and do not need the money that could be generated from a sale of the stock.

(v) This can be done on a more substantial basis by taking advantage of the one-time $1,000,000 gift tax exemption ($2,000,000 for a married couple who takes advantage of a gift splitting option). Since this $1,000,000 exemption is not indexed for inflation, for people of substantial means, significant tax savings can be generated by using the exemption sooner rather than later.

(e) There are a number of other techniques which are more complex and require the assistance of sophisticated tax counsel to ensure they are properly set up.

(i) *Grantor Retained Annuity Trusts (GRATs)* - Using a GRAT allows a business owner to transfer substantial assets to a trust on an attractive basis for gift tax purposes.

(A) The GRAT provides an annual annuity to the grantor for a specified number of years.

(B) At the end of the annuity term, the property passes outright to the children or to a trust for the benefit of a spouse and/or younger generation family members without further transfer tax consequence.

(C) As a result, owners who have businesses which are appreciating at a rate in excess of the discount rate inherent in the IRS' annuity tables can use a GRAT to effectively remove assets from their estate on a gift-tax-advantaged basis.

(D) However, in order for the strategy to work, the owner must survive the annuity term. Thus there is a mortality risk associated with this planning.

(ii) *Installment Sale to Grantor Trust*

(A) In this scenario, the grantor creates a trust which is known as a "defective grantor trust" and contributes seed money to the trust equal to approximately 10% of the value of the interest in the business that will be bought by the trust.

(B) The business owner then sells the stock to the grantor trust which uses the cash gift as a 10% down payment and issues an installment note for the other 90% of the purchase price.

(C) The plan is to repay the installment note during the business owner's lifetime with profits from the business.

(D) The effect is that the value of the installment note, rather than the value of the company, is included in the owner's estate. Thus, all growth in excess of the interest rate on the promissory note inures to the benefit of the grantor trust.

(E) While situations vary from family to family, this is often the most efficient way to transfer an interest in a business from one generation to the next.

(iii) Another technique which is sometimes used is an "Estate Freeze." This is a strategy which requires the recapitalization of the company into preferred and common stock.

(A) The effect of the recapitalization is typically to "freeze" 90% of the current value of the company in the preferred stock and allow all appreciation (beyond the dividend on the preferred stock) to flow to the common stock which is only worth 10% of the current value of the business.

(B) Since the common stock is of little value immediately after the recapitalization, the business owner can transfer the common stock to whomever he wants with little or no gift tax consequences.

(C) If the business grows at a rate in excess of the dividend on the preferred stock, all such future growth will inure to the benefit of the new owners of the common stock.

(iv) Use of Life Insurance to help fund purchase obligations at death of the older generation member.

(f) *The Role of Charity*. In certain circumstances, it may be appropriate to consider the use of a number of charitable vehicles for transferring the economic interest in a business. This decision is completely devoid of the issues surrounding the management of the business.

(i) For instance, if the senior generation member does not have any children or other descendants to whom they desire to give the economic benefit of the business, then one possibility is to give the economic interest to charity. The individual may want to effectuate a desired charitable purpose.

(ii) By giving the economic interest to charity, during lifetime, the individual would obtain a charitable income tax deduction, and the asset is removed from the person's estate for estate tax purposes.

(iii) By giving the economic interest to charity, upon death, the individual's estate would obtain a charitable estate tax deduction and would be alleviated of paying estate taxes with respect to that portion of the company which was given to charity.

(iv) There are a number of ways to make the donation to charity. What a number of wealthy clients prefer is the use of a private foundation. Other charitable techniques such as charitable trusts can also be utilized.

6. IMPLEMENT THE OWNERSHIP SUCCESSION PLAN. This stage is relatively simple compared with the other stages.

(a) After you have decided on an ownership succession plan with the advice of your business advisors, accountants and lawyers, it is essential that you follow up and make sure that the necessary documents are drafted and executed.

(b) Once the documentation is in place, the plan should be communicated to each affected person so that they are aware of the nature, extent, tax consequences and ***responsibilities*** associated with their interest in the business.

7. CASE STUDIES.

(a) **Spouse Runs Business / One Child Appears to be Successor**. In this case study, only one spouse is involved in the business. There are four children but only one is involved in the business. The spouse has decided that the child involved in the business will be the successor manager of the business.

(b) **Father Established Business / Second Generation Transition Issues / Managers with Limited Participation (some Equity Ownership but Always a Minority)**. In this case study, the father began the business many years ago. The father has dropped out of active management of the business and two of his three children are now actively running the business. In this case, there are many business lines, in each business line there is a manager who is a third party who has a small economic interest.

(c) **Smaller Business / Run By Managers / Family Members Will Have Control / Managers will have Economic Equity Ownership**. In this case study, the company is owned by three principal owners from the same family, as the older generation members pass away the fractional ownership in the business is becoming smaller for each individual descendant (or a trust for the descendants). The family retains majority control; however, the managers of the business, who are not family members, have been given the remaining equity ownership as incentive to keep the businesses productive.

(d) **Larger Business / Run By Managers / Family Members will Have Veto Authority / Economic Equity Interest Generally Maintained in Family / Executive Compensation Arrangement**. This case study is the most complicated. The senior generation member is very particular about his family retaining all equity interests in the business after he passes away. However, there is not one clear descendant who would run the business after his death. In addition, the company is run day-to-day by extremely competent non-family members. There is a need to keep these non-family members incentivized even after the death of the senior generation member. Accordingly, an executive compensation arrangement was created. In addition, upon the death of the senior generation member a committee is created to run the business. All of the family members combined can outvote the remaining members of the committee. However, non-family members can have significant input in the decision making process.

8. CONCLUSION. While it takes planning and several years of implementation, a properly designed and implemented plan can build a stronger family unit and a stronger business capable of weathering the inevitable transition. The benefits of succession planning are:

(a) Creates a guaranteed market for the business interest.

(b) Allows for those interested in the in continuing the business to do so without interference from the deceased owner's heirs

(c) Provide liquidity for the estate of the deceased owner by turning the business interest in to cash.

(d) Establish the value of the business for death tax purposes.