Succession Planning: Continuing Success

Northwestern Mutual®

Succession Planning:
CONTINUING SUCCESS

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Succession Planning:

CONTINUING SUCCESS

The Need for a Succession Plan

Whether large or small, whether organized as **sole proprietorships, partnerships, limited liability companies,** or **corporations**, all businesses need to address succession.

In addition to the issues of family succession, devising a succession plan is crucial in case of disability, retirement, or death, or in the event that growth in your company changes your role away from "hands on" to a more managerial focus. Your successor can then assume your duties as a "doer," and free up your time so you can direct your attention to larger issues.

Business continuity planning not only benefits the withdrawing owners and their families, but also the remaining owners and their families, the employees, and the business entity itself.

The owner's primary goals in a succession plan are the following:

- To stabilize the business
- To facilitate the transfer of the business in accordance with the owner's wishes
- To minimize eventual estate taxes
- To maximize the wealth passed on to the next generation within the family

As we shall see, many factors influence the direction of a succession plan, and there are no iron-clad solutions. However, based on the goals set forth in the initial phase of the process, priorities and points of emphasis emerge. For example, focus should be on estate planning if the owner wants to transfer business interests to family members while incurring the least amount of transfer or gift tax. If a sale to a third party is the primary objective, structuring an appropriate buy-sell agreement and income tax issues may overshadow gift and estate tax issues.

Procrastination and Facing Reality

Many business owners may resist facing succession issues or feel they can delay thinking about it. Most family businesses have unique characteristics. Envisioning the future under new leadership is daunting.

Owners who are accustomed to controlling and managing all aspects of the business sometimes have difficulty "letting go." After all, the success

of the business has been achieved largely through the total commitment of the owner—it's the owner's "baby."

An owner may have greater difficulty grooming a family member than an outsider for succession because of the overlap of family and business boundaries. Sometimes, disharmony among family owners can paralyze mutually beneficial planning. Often overlooked is the personality of the owner and the effect of his personality on other family members. Almost everyone has a story about family members who professed to love each other dearly, but who were constantly at each other's throats when it came to running the family business; or, about the father who dreamed of one day turning his business over to his son or daughter, but who couldn't recognize that his child had different ideas about the future direction of the company.

Finally, some families just don't discuss money or inheritance issues because such discussions may be perceived as a lack of family trust. Care must be taken to ensure that these kinds of issues will receive open and honest discussion. **Denial will not change the reality that, when a company doesn't have a succession plan in place, the impact on the company can be devastating and sometimes create irreversible damage.**

The fact that participants may have different agendas and goals will not doom the process, but failing to recognize and deal with such differences almost surely will be disastrous. Indeed, planning *early* and *carefully* for succession has been cited as one of the most important characteristics found among businesses that have survived a generational transition.

Step One:

DEVELOPING THE PLAN—AN OVERVIEW

Business continuity planning is the dynamic process of planning for the time when the owner will have a less active role in the business. Regardless of the actual strategies employed, all plans must address both management succession and ownership succession.

The first question should be: Will ownership and/or management remain in the family and, if so, in what capacity? If your intent is to keep your business within the family, you'll need to determine your family's needs and interests, as well as the needs of the business. A family conference should be called to explore the relationship between the business and the family.

Here are some areas to explore:

- Discuss with members of your family who will participate in the business and in what capacity.
- Are some family members interested in maintaining jobs within the business, even though they may not be part of key management?
- What compensation should non-participating family members receive?

Ask Yourself These Questions:

Whether succession involves a gift or a sale to family members or an unrelated party, these questions must be addressed:

- Who will ultimately own your company?
- When is the plan activated or how is it triggered?
- How will the price be determined?
- How will the purchase be financed?
- What will be the effects of a change in ownership and management on the operation and value of the business?
- How will management retain key employees?
- Will your company have enough cash reserves to carry it through the transition phase?
- How can income and transfer taxes be minimized?

Once you have answered these questions, the process of succession planning will begin.

Step Two:
GATHERING & ANALYZING RELEVANT DATA

Before a plan can be developed, goals and objectives must be identified, various business and personal issues must be addressed, and a large amount of information must be gathered.

Compiling Business Data

You will need to analyze your company's financial position within the context of financial forecasts for your industry and the larger economy. Financial statements, detailing the company's cash flow and assets and liabilities, should be prepared by an outside accountant. You will also need to prepare thorough job descriptions of all key positions and determine areas of responsibility. In conjunction with this analysis, you will be outlining the qualifications necessary for your successor. You will want to consider a candidate's job experience and academic background, as well as how both will fit into the successful operation of your business.

Training Potential Successors

While someone can instantly become the owner of a business, becoming an effective manager of that business is not an overnight process. Many businesses find that mentor-type relationships, in which the next generation of managers are immersed in the day-to-day operations of the business, enable potential successors to grasp the strengths and weaknesses of the company. The transition between relinquishing control of your business and your successor taking the helm will hinge, in large part, on the training and information you provide, so that the successor fully understands the challenges that lie ahead.

Compiling Personal Needs

Among the personal issues that need to be addressed are your financial needs and desires. How much money do you want or need to take out of the business? Will your withdrawal from the business be partial or complete? When will the withdrawal take place? Compiling personal financial data is just as important as compiling business financial data, because a good succession plan involves satisfying not only the objectives of the business, but the owner's personal objectives as well.

Step Three:
REFINING THE PLAN—STRATEGIES & TECHNIQUES

Assuming the business will be sold, the strategies and techniques available will depend on the *form* of the business entity, and on determining *what* is being sold and *who* is the potential buyer. For example, is the sale an asset sale or a stock sale? Is the potential purchaser another current owner, a family member, a group of key employees, or an unrelated third party?

Specific strategies begin to emerge depending on the form of the business. Because most family businesses are either incorporated or partnerships, we shall only briefly mention the implications of selling a sole proprietorship before turning our attention to the issues more common to partnerships and corporations.

Planning for the sale of a sole proprietorship does not offer the same flexibility as that available to partnerships and incorporated businesses.

The sale of a sole proprietorship is a taxable event. The sale does not involve a legal entity separate and distinct from its owner. The gain in each business asset is triggered upon the sale. Consequently, the planning focus is centered around structuring the sale to achieve the lowest possible tax cost by taking advantage of favorable long-term capital gains rate (15% through 2010 for taxpayers in the top four brackets). The holding period of an asset isn't the only factor; you must also properly classify assets to maximize use of the capital gain rate.

In contrast to sole proprietorships are closely held businesses, in the form of partnerships and corporations owned by a small number of individuals.

Ownership of the business is not available to the general public. Securities are not listed on the stock exchanges, and there is no readily available means for determining the fair market value of these businesses. Consequently, alternative valuation methods must be used before the price can be fixed.

Multiple factors affect the valuation process; the more complicated the business, the more difficult the process will be. Not only must **assets** be valued but also **liabilities**. In addition to obvious or admitted liabilities (for example, outstanding debt), there may be hidden or potential liabilities such as violations of hazardous waste laws or fair labor standards, problems with existing contracts, and unfunded pension liabilities.

Whether your business is a corporation, partnership, or sole proprietorship, tax issues are complex and can have a dramatic effect on the ultimate proceeds received from the sale or the accepted valuation. It is imperative, therefore, that you consult with your financial advisor and especially your attorney.

Step Four:
VALUATION METHODS

The following are some of the valuation methods you can use when selling your business:

1. **"Fix the price."** Many owners simply fix the price of their business, although it is more common to obtain a formal business appraisal. Both buyer and seller can arrange for independent appraisals, with the individual appraisers choosing a third appraiser.
2. **Establish the value of the company based on book value,** which is simply an evaluation of the company's balance sheet at a specific point in time. This is usually done by the company's accounting firm, using generally accepted accounting standards. Book value may not, however, reflect the current fair market value of the company, and therefore, an appraiser's valuation, using book value as a starting point, may be necessary.
3. **Fix the price by capitalizing the earnings of the business.** Under this method, the business's net income is capitalized at a specific rate (called the "multiplier") with the result reflecting the total value of the business. For example, a business with net income of $1,000,000 and an 8% capitalization rate would be valued at $12,500,000 (1,000,000 ÷ .08). A reasonable approach would be to average net income over a certain number of prior years, perhaps giving greater weight to recent years, and use a capitalization rate consistent with industry standards.

It is both acceptable and often advisable to use a *combination* of methods. For example, using asset valuation alone can understate the value of the business, since, by ignoring earnings, the future capabilities of the company are excluded. The goal is to reach a valuation that fairly compensates the owner for his interest in the business and that makes the business attractive to the potential buyer. If done properly, both parties will come to view the price as a "win-win" situation.

Caution—Since valuing a business can be more of an art than a science, potential tax problems can be avoided by consulting the most recent IRS Valuation Guide as a starting point. The IRS is interested in having the business fairly priced for income, estate, and gift tax purposes. This is especially important if a related party is at the other end of the transaction. Some of the factors the IRS will look at are the following:

- The nature and history of the business.
- The economic outlook for the business's industry.
- How assets and earnings are being valued, and the existence of intangible assets, including goodwill.
- The selling price of comparable businesses using, if possible, acceptable industry formulas.

Step Five:
BUY-SELL AGREEMENTS

While each specific business continuity strategy depends on the purposes and objectives the owners are trying to accomplish, almost all succession plans begin with some sort of buy-sell agreement.

In its simplest form, a buy-sell agreement is an agreement between two or more parties, whereupon a triggering event, one party has an obligation to buy and the other has an obligation to sell his or her interest in the company. Do not consider drafting a buy-sell agreement without consulting your attorney.

In addition to fixing the price, one of the more important purposes of a buy-sell agreement is to restrict ownership. While business owners usually don't intend for their ownership interests to fall into the hands of someone who is not part of the succession plan, this may indeed happen despite good intentions.

For example, the divorce of an owner could result in the ex-spouse gaining control of the stock of the company which could then be transferred to another party. Also, an owner's creditors could force the passing of ownership interests to outsiders. With closely held corporate stock, it is generally advisable to try to prevent passing of such stock to a third party by placing a restrictive legend on the face of the stock.

Buy-sell agreements also help to define a market for the eventual sale of an ownership interest. Potential buyers include the other owners, interested family members, and unrelated parties including the employees of the business or owners of similar businesses. The business needs to know in advance what the potential price and market is in order to limit the disruption caused by a withdrawing owner.

Three general methods for structuring buy-sell agreements within a company:

1. **The first technique is called a redemption or entity purchase agreement** because the entity (the company) is the purchaser. The company is assumed to be a C-corporation for the following discussion. Upon some precipitating event (for example, retirement or death), the company agrees to buy back the shares of the withdrawing shareholder. Redemption agreements are commonly used when the owners have relatively equal ownership interests and want to maintain that equal ownership among the remaining owners, the ages of the owners are different, and family attribution problems (discussed below) do not exist.

   Among the disadvantages of a redemption plan are the lack of "step up" in basis for the surviving shareholders and a potential squeeze on the company's capital in order to accomplish the purchase. Family attribution issues can subject the transaction

to double tax. As a general rule, any payment, including a payment to redeem stock, by a corporation to a shareholder will be treated as a dividend unless it qualifies as a sale or exchange. However, an exception to the dividend treatment provides for treatment as a capital transaction if all of a shareholder's stock is redeemed, thus terminating the shareholder's interest in the corporation. The problem arises in dealing with the definition of "all" under the "attribution of ownership" rules contained in Section 318 of the IRS Tax Code. Simply put, a shareholder would be considered to own, by application of the family attribution rules, shares owned by his spouse, children, parents, and grandchildren. Consequently, as a general planning principle, most family-owned businesses face the possibility of dividend tax treatment upon the sale of ownership interests because shares are usually owned by multiple family members. These rules are quite complicated, but techniques do exist for avoiding the onerous consequences of the attribution rules. *The application of these techniques requires expert legal advice.*

2. **The second technique is a cross-purchase agreement, which is a buy-sell agreement solely among shareholders.** Again, upon the occurrence of some previously defined event, one shareholder (or his estate in the case of death) must sell, and the remaining shareholders must buy, his stock. Cross-purchase agreements have been used successfully in situations where attribution problems exist, or where shares are owned unequally and an owner of a smaller number of shares has the financial ability to purchase more shares. The attribution rules do not apply to cross-purchase agreements because the remaining owners, rather than the corporation, are buying the withdrawing shareholder's interest, and the tax consequences of dividend treatment only apply to corporate redemptions. While a cross-purchase plan does provide for a "step up" in basis for the surviving shareholders, its main disadvantage is that the purchase is accomplished using personal dollars.
3. **The third technique is a hybrid or combination agreement in which both the business entity and the remaining shareholders agree to buy the withdrawing shareholder's stock.** Consider a company with two shareholders, each owning 100 shares of stock. With a combination strategy, there is a stock redemption (entity purchase) agreement for 50 shares, and a cross-purchase agreement for the other 50 shares of stock.

Wait-and-See Buy-Sell Agreement

A variation on the traditional buy-sell theme is what has been called a "wait-and-see" buy-sell agreement. In this arrangement, the business owners mutually agree to buy and sell their respective business interests under specified conditions. Typically, this would involve the business having the first option to purchase a decedent's interest. However, if it is not exercised, the option passes to the surviving owners. Then, if neither option is exercised, the business has a mandatory obligation to purchase the decedent's interest.

The main advantage of this technique is that it allows the owners to delay some decisions until the time of purchase. However, while it may be attractive on the surface because of its flexibility, this strategy has the undesirable quality of not knowing who the purchaser will be, complicating the funding of the agreement. Obviously, buy-sell agreements can be intricate and detailed documents.

Step Six:
FUNDING THE AGREEMENT

An agreement would not be complete without addressing how the purchase price will be paid. Two of the most common funding vehicles are **life insurance** and **ESOPs** (**employee stock ownership plans**).

Life insurance can be a simple funding vehicle that is relatively easy to administer.

The availability of a death benefit from life insurance ensures that adequate liquidity will be available when an owner dies, thus avoiding a potentially adverse impact on working capital. Without life insurance, the business or surviving owners may be contractually required to purchase the seller's interest at the seller's death, but lack the necessary liquidity. The party obligated to buy the business interest should therefore be both owner and beneficiary of the policy. If a cross-purchase agreement is used, each owner owns an insurance policy on the life of every other owner. If the agreement is structured as a redemption (entity purchase), the business usually carries a policy on the life of each owner. The party obligated to buy the business interest should be both owner and beneficiary of the policy.

Another source of funding is an ESOP (Employee Stock Ownership Plan).

This is an employee benefit plan designed to invest primarily in the stock of the sponsoring business. Over the years, a number of major tax incentives have been enacted that make an ESOP attractive as an employee benefit plan, as a technique of corporate finance, and as a tool for estate planning. One tax provision attracting wide interest is the tax-deferred "rollover" of the proceeds of the sale of "closely held" stock to an ESOP under Section 1042 of the IRS Tax Code, allowing a number of common planning problems to be addressed on a more favorable tax basis. For example, an ESOP can be used to buy out the interest of a retiring owner, serving as an alternative to selling the business to an outsider. This is especially useful in situations in which other family members, or a key employee group, wish to maintain control of the business.

In a typical ESOP-based buy-out, the ESOP borrows funds from a commercial lender and uses the proceeds to purchase the shares of the withdrawing shareholder. The corporation is then entitled to tax deductions for both the principal and interest paid because the business is, in effect, "making contributions" to the ESOP in periodic amounts sufficient to amortize the loan. The withdrawing shareholder, who may have a large portion of his wealth invested in the company stock, is able to effect a tax-deferred exchange of his buy-out proceeds, by investing

such proceeds in other qualifying securities within 12 months of the buy-out. Once the exchange is accomplished, the previously concentrated wealth can be diversified, which may be an important investment goal as retirement approaches.

One of the disadvantages associated with ESOPs is the sharing of earnings and, perhaps, control of the company with employees. In addition, all of the general tax and employee benefit laws that apply to other tax-qualified plans also apply to ESOPs.

Early in our discussion, we stated that an important goal in a succession plan was minimizing eventual estate taxes. However, estate planning for business owners involves a consideration of non-tax objectives along with the goal of limiting the size of the taxable estate. Some of the non-tax objectives, such as to whom property will be transferred and whether such transfers will take place during lifetime or at death, will have been addressed in the early phases of developing the succession plan. Divorce and second marriages can complicate succession planning and present special estate planning challenges. For example, a business owner who remarries may want to leave her business to her children, while her new spouse may be more interested in how the succession plan provides for him and his children.

Further complicating the non-tax issues is the matter of equal distribution to one's children. Does $50,000 "worth" of stock in a closely held corporation equate to $50,000 in cash? The value of the stock is based on its value as a "going concern;" without the effort required to keep the business going, it may really have very little value. Very often, a succession plan is not implemented because there is no apparent solution. The business is simply left to the children collectively with the hope that they can come to an equitable solution. This may be unrealistic in light of the circumstances.

Your Business Is an Asset.

Since an owner's interest in the business is an asset included in his estate for estate tax purposes, the value assigned to his ownership interests will drastically impact the tax eventually paid by the estate. It is possible, under specific conditions, to fix the value of the owner's business interests for estate tax purposes. Case law permits a buy-sell agreement to fix the value of a business for federal estate tax purposes if the agreement is binding both during life and at death; the arrangement does not seek to pass the business interest to heirs for less than adequate and full consideration; and the agreement is a bona fide business arrangement.

Section 2703 of the IRS Tax Code further stipulates that the terms of the arrangement must be comparable to other agreements made at arm's length. If this condition is not met, taxpayers cannot rely on the value fixed in a buy-sell agreement if such agreement is made, or substantially modified, after October 8, 1990. The problem created by this provision is the determination of just what a "comparable arrangement" might be. To this date, both Congress and the courts have provided few general guidelines. Significant ambiguity and a large degree of

uncertainty still exist. What is clear is that agreements made prior to the effective date are "grandfathered" unless "substantially modified," and extreme care must be taken when changing such prior agreements.

Family Limited Partnership

Among the vast array of estate planning techniques available, the use of a **family limited partnership (FLP)** merits special consideration because it is an attractive vehicle for both managing a family business and for protecting an owner's wealth.

As an asset protection tool, an FLP is designed to take advantage of Section 703 of the Revised Uniform Limited Partnership Act. This act provides that a creditor's interest against a partner is limited to distributions made from the partnership, and not to the partnership interest itself. Since the general partner, who is controlled by a family member, determines the timing and amount of distributions, the creditor's ability to gain satisfaction under a judgment can effectively be blocked. The ultimate deterrent for a "judgment creditor" is that, by obtaining a judgment against a partner, the creditor is treated as being the owner of a portion of a partnership interest. Therefore, the creditor must pay income tax on his "share" of the partnership income as determined by the judgment, even though he does not receive an income distribution.

As a wealth transfer tool for managing the family's enterprises, the FLP maintains control through the general partner. The business owner can give away partnership interests, thereby reducing the size of his estate for estate tax purposes while retaining control of the operations of the business.

The FLP can be used to manage the assets of a family that include one or more business interests. An FLP is one of the ways to allow for the transfer of interests small enough to qualify for the annual gift tax exclusion (available on annual gifts up to $13,000, or $26,000 in 2010 if both spouses make gifts or if an election to split the gift is made). Additionally, partnership interests gifted may receive a minority discount. The minority interest discount concept is based on the notion that when an ownership interest lacks voting control, that interest is worth less than its pro-rated share of the underlying asset. Recently, the IRS conceded that minority discounts will still be allowed, even if the aggregated interests held by family members constitute a controlling interest. This means that a business owner can get a minority discount (lower valuation) when gifting minority portions, and a minority discount for owning a minority interest in his taxable estate. This favorable tax treatment can provide significant leverage in transferring assets for estate tax purposes.

Summary:
CONTINUING SUCCESS

We have taken you on a long journey, starting with some general considerations and progressing through specific strategies. Some of the topics covered may seem like "common sense" issues, but good sense is anything but "common" when it comes to family business planning.

Since you will have your own team of professionals guide you in crafting your unique succession plan, remembering the main theme of this discussion is far more important than any of the details. The two most common reasons for the low rate of successful transitions in closely held businesses are failing to plan, and attempting to implement a plan in the face of unresolved family conflicts. Although you may be years away from a planned withdrawal from your business, sudden illness, disability, or death can force your "untimely" withdrawal. So get professional guidance and start assessing your business needs now!

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