

Family Business Succession Planning – Non-Tax Aspects

Family businesses generate almost half of the U.S. GDP and employ the bulk of the U.S. workforce. Despite these impressive statistics, studies estimate that only 30% of family businesses survive the second generation and only 10% survive the third generation. Reasons for this high failure rate include the lack of adequate succession planning by most family businesses and insufficient planning to minimize transfer taxes across generations.

Broadly speaking, business succession planning consists of transferring ownership and control of the business while minimizing income, gift and estate taxes. Within these broad conceptual categories are a virtually infinite array of combinations that should be customized for each business and family. For a family business, succession planning must also address the emotional issues and dynamics of the family. After the requirements to protect and continue the business are established, the business succession plan must be coordinated with estate planning to minimize taxes.

Business succession planning issues may be grouped into three broad categories of management, ownership, and tax issues. Adequate planning requires a multi-disciplinary team of professionals including an accountant, attorney, financial/insurance advisor, business appraiser and, for more complex cases, family business consultant.

This overview focuses on non-tax legal issues frequently encountered. It is not intended to be and cannot substitute for legal advice applied to the facts of a particular family business.

I. Succession Planning Overview

A. Basic Outcomes

- sale to third parties, employees or active family members – see Part III below
- gifts to family members – see Part IV below
- liquidation

B. Basic Components of a Succession Plan

- Identify primary objective
 - Legacy - preserve the legacy family business to (i) infuse future generations with business ambition, family values, relationships and long-term wealth-building goals, and (ii) provide security for valued employees
 - Wealth Management - the business is sold (to family members desiring to own/operate the business or to non-family) and the sales proceeds are distributed to family members for investment in other businesses or passive investments
- Business Analysis
 - Valuation/Appraisal
 - Mission and strategic plan
 - SWOT (strengths, weaknesses, opportunities and threats) Analysis
 - Cash flow and capital needs of business
 - Liquidity demands arising on owner's death
 - Effect of owner's death on customer, creditor and employee relationships
 - Recommended reading - "The E Myth" by Michael E. Gerber

- Management Issues
 - “Family-first” vs “business first” focus – how should business decisions by the next generation be prioritized between needs of the business and needs of the family?
 - Is a leader available in the next generation who possesses the passion and competence to implement a shared vision for the business?
 - Should non-family run the company?
 - What kinds of incentives are necessary to attract and retain top employees?
- Ownership Models
 - Owner-Employee - first generation owners frequently work in the business and derive “ownership benefits” from compensation and other deductible perks.
 - Hybrid Ownership - sibling- or cousin-owned companies (typically second- and third-generation) use a hybrid ownership model with some owners active in daily operations and other owners having varying governance/oversight roles
 - Owner-Investor - ownership held in family entities such as limited liability companies (LLCs), limited partnerships, corporations or trusts with governance/oversight policies established by an active board. Best available management is hired without regard to family status.
- Personal Family Issues
 - Fairness/equalization issues between active and inactive children
 - Financial needs of the senior generation
 - Emotional and family dynamics (including spouses)
 - When does senior generation step-down?
- Implementation Schedule
 - Begin now to avoid “damage control” succession due to disability or unexpected death
 - Planning takes time to properly analyze issues, obtain consensus and commitment of stakeholders (family, employees and business associates), groom successors and implement planning team recommendations
 - Establish schedule with milestones for review and accountability
 - Conduct periodic reviews to adjust succession plan as changes occur

II. Buy-Sell Agreement

A. Critical for Multi-Owner Businesses. The purpose of a Buy-Sell Agreement is to provide business and ownership continuity while minimizing disputes.

B. Definition. Sometimes referred to as a business “pre-nuptial” agreement, a Buy-Sell Agreement is an agreement among the owners of the business to establish:

- restrictions against undesired ownership transfers
- procedures for permitted ownership transfers
- representation on the board or other governing body of the business
- rights and obligations of owners with respect to a future sale of the business
- vesting and repurchase rights of a withdrawing employee’s ownership interest

- confidentiality and noncompetition obligations
- approval requirements for major transactions
- dispute resolution procedures

C. Sample Issues Addressed

- The following events typically trigger a redistribution of ownership:
 - death
 - disability
 - termination of employment (voluntary or involuntary)
 - retirement
 - proposed transfers to third parties
 - involuntary transfers (i.e., bankruptcy or divorce)
 - management impasse or disputes
 - supermajority vote to sell the company (drag-along rights)
 - permitted joinder by other owners in an owner's sale (tag-along or participation rights)
- The method(s) for determining the price of ownership interests purchased under the Buy-Sell Agreement should be specified, together with the payment terms (cash or installment payments) and any collateral requirements for deferred payments
- Insurance funding of purchases by the company and/or the other owners is frequently specified.
- Mandatory minimum distributions of income to owners to pay income taxes on undistributed S corporation, LLC or limited partnership income taxable to them

D. Integration with Succession Plan. The Buy-Sell Agreement should be consistent with the succession plan.

III. Sale of Business

A. Preparatory Actions. As with selling a house, the business should be in good order before being put on the market. Preparatory actions include:

- Valuation
 - To facilitate the valuation process, the owner or his/her accountant should submit to the business appraiser:
 - an “adjusted balance sheet” listing the company’s assets at estimated fair market value and eliminating assets and liabilities that will not be transferred (such as cash, any personal vehicles and associated obligations, etc.)
 - a three-year “discretionary income” spreadsheet adding back to the business’ taxable income: compensation paid to the owner(s); depreciation; interest income and expense; expenditures motivated by “tax avoidance” and any other items that are not integral to the business
- Expense Control – if the most heavily weighted valuation component is capitalization of the business’ cash flow, each dollar of savings will have a multiplier effect on valuation

- Records
 - Conform financial records to generally accepted accounting principles (GAAP)
 - Obtain a review or audit of the financial statements of the business
 - Bring contracts and other records up-to-date
 - Update SWOT analysis and business plan to reflect focus on current opportunities, competitive advantages and improvement of weaknesses (sometimes identifying additional resources for growth attracts buyers who can provide the resources for an immediate ROI increase)
 - Create reports showing historical and projected business growth
 - Prepare detailed asset schedule and detailed records of completed and pending jobs/sales/transactions
- Enhance business image
 - Update web site and printed marketing materials
 - Clean up facilities – dust inventory storage to reduce appearance of obsolescence, upgrade exterior landscaping, etc.
 - Obtain customer and business partner testimonials
- Information systems (including accounting software) should be “standard” to facilitate buyer utilization
- Reduce excessive concentrations of suppliers and customers
- Groom strong employees and qualified managers to reduce dependence of business on current owner(s)
- Negotiate key personnel employment/retention agreements
- Execute noncompetition and confidentiality agreements with all personnel/consultants
- Intellectual property
 - protect trade marks, patents and copyright by registration
 - protect trade secrets by confidentiality agreements and other actions reasonably necessary to preserve secrecy
 - confirm adequacy of licenses for intellectual property used in the business
- Conduct a “sell-side” due diligence review ¹ to anticipate buyer issues and avoid “surprises”
 - maintaining seller integrity/buyer trust is critical
 - review material contracts, leases and loan documents for imminent expiration and for clauses prohibiting assignment, change of control or ownership transfers
- Identify obligations personally guaranteed by selling owner(s) for refinancing or release
- Engage legal counsel and accountant experienced in selling businesses
 - Obtain legal review of business structure to minimize owner’s exposure to post-sale liabilities

¹ Due diligence is an in-depth investigation by the buyer to ascertain matters potentially affecting the business. Typically an unaffiliated buyer will submit a “due diligence” questionnaire covering a broad range of issues to identify areas of concern and to eliminate those of no concern. Seller responses frequently form the basis of the representations and warranties in the purchase agreement.

- Analyze and, if feasible, settle pending litigation by or against the business
- Analyze potential environmental liabilities
- Due to conflicts of interest, the same legal counsel should not represent the buyer and the seller.
- Determine optimum tax-advantaged sale method ²
- Analyze sale alternatives
 - sale of ownership interests or assets
 - full or partial sale, with or without an auction
 - minority equity investment/recapitalization ³
 - Should any assets or lines of business be retained for post-sale income to selling owner(s)?
- Identify and contact potential purchasers through existing contacts or, after your attorney's review of the contract, engage a business broker or investment banker to market business by auction or negotiated sale
- Analyze potential buyer's financial and operational capabilities to complete the transaction and to meet required licensing standards
- Discuss potential sale with key employees and obtain agreement to maintain confidentiality ⁴
- Divide due diligence into phases
 - Phase 1 – summary business information is delivered after the potential buyer has been qualified and a confidentiality agreement has been signed
 - Phase 2 – business information provided after a letter of intent is executed
 - Phase 3 – highly sensitive business information should be made available only after all other buyer closing conditions in the purchase agreement have been satisfied.

Caveat: No confidential business information should be disclosed prior to buyer's execution of a confidentiality agreement. Even after the confidentiality agreement is signed, extremely sensitive business information should not be disclosed until all other buyer closing conditions are satisfied or waived. ⁵

² While each deal is different, the following generalized rules provide a starting point. Buyers generally prefer to purchase the assets of an appreciated business to increase their basis for tax purposes for recovery through future depreciation and amortization. Owners of a C corporation generally prefer to sell stock since an asset sale may result in taxation of both the corporation and the shareholders. If the business is held by an S corporation, partnership, or limited liability company taxed as a partnership, complex tax considerations affected by the character of the assets sold generally determine the owner's tax liability.

³ New owners should be required to execute the Buy-Sell Agreement.

⁴ Beware of shifting employee loyalties from current owners to the leading purchaser candidate.

⁵ Although a confidentiality agreement provides legal recourse for buyer violations, the remedy may not be satisfactory from a practical perspective. The damage to the business will have already occurred, and litigation is expensive, time consuming and frequently takes years to conclude.

B. Sales Documentation

- Letter of intent
 - expressly nonbinding major transactional terms for preparation of definitive sales agreements
 - expressly binding provisions for confidentiality of disclosed information, non-solicitation of employees, nondisclosure of negotiations, allocation of costs and dispute resolution.
- Purchase and Sale Agreement (including obligations to refinance or obtain release of seller guaranties; expect the buyer to require a noncompetition agreement with each selling owner)
- Consulting and employment agreements with selling owner(s) for continuity and income
- Security Agreement for deferred payments (including earn-outs)
- Buyer's promissory note, personal guaranty and security agreement for Seller financing

C. Sale to Employees

- Preparatory actions are generally same as described in Part III.A except due diligence may be reduced for key employees who have been involved in the business. Depending on degree of owner involvement in the business, the purchasing employees may have superior knowledge about the business requiring the reversal of business information disclosures
- Sales Documentation is generally the same as described in Part III.B except representation and warranties of selling owner(s) may be reduced
- Leveraged buy-out or seller financing may be necessary for purchasing employee(s) to pay the purchase price
- Sale to an employee stock ownership plan (ESOP) - a defined contribution retirement plan designed to provide employees with an opportunity to invest in employer securities.⁶
- If less than all of the ownership interests are sold, new owners should be required to execute the Buy-Sell Agreement.

D. Sale to Family Members

- Preparatory actions are generally same as described in Part III.A except due diligence may be reduced for active family members.
- Sales Documentation is generally the same as described in Part III.B except representation and warranties of selling owner(s) may be reduced
- Leveraged buy-out or seller financing may be necessary for purchasing family member(s) to pay the purchase price
- If less than all of the ownership interests are sold, new owners should be required to execute the Buy-Sell Agreement.

⁶ Benefits of ESOPs include pre-tax funding of the stock purchases. Due to regulatory requirements and administrative complexities, ESOPs are not appropriate for all situations.

IV. Transfer to Family Members other than by Sale

A. Transfer Methods

- Direct and Indirect Gifts
- Redemption of transferring owner's interest (leaving other owner's interest outstanding)

B. Non-Tax Issues

- New owners should be required to execute the Buy-Sell Agreement
- Fairness/equalization issues between active and inactive owners
 - Equal transfers to children are not required by law.
 - Sale of business to active children at fair market value can provide the most equal treatment (but may not be the most tax efficient)
 - Distribution to inactive children of non-business assets in an amount having equal value to the business
 - What is the value of the business - "fair market value" of the business as a whole or the discounted value of the ownership interests?⁷
 - Insurance proceeds are frequently used to supplement the value of non-business assets as necessary
 - Real estate used by the business may be transferred to inactive children for leasing to the business. *Caveat*: The property should be transferred subject to a long-term lease with purchase option to prevent "unreasonable" landlord actions
 - Award equity to active children as reimbursement for previously inadequate compensation
- Protections for selling and inactive owners
 - Retention of Control
 - Limited liability companies and limited partnerships may be used to transfer ownership to children while senior generation retains control
 - Senior generation owns voting shares of a corporation and transfers ownership to children by nonvoting shares
 - Ownership interests may be placed in a trust with voting exercised by a board or committee of trustees
 - Income protection for senior generation and/or inactive owners
 - Issuance of preferred stock with cumulative dividends and/or right to require repurchase by the business on pre-determined terms
 - Installment sale promissory notes
 - Salary continuation, consulting and employment agreements
 - Approval requirements for "major" actions
- Contractual protections and incentives for key employees
- Contractual transfer of control to active children on death/disability of currently controlling owner

⁷ Though the use of limited liability companies and limited partnerships, ownership interests are discounted for lack of marketability and control.

VI. Tax Minimization Techniques. While legislative revisions are expected,⁸ the federal estate tax exemptions and maximum tax rates are currently:

<u>Year</u>	<u>Exemption</u>	<u>Tax Rate</u>
2009	\$3,500,000	45%
2010	---	0%
2011+	\$1,000,000	55%

Although beyond the scope of this paper, various methods exist to reduce estate and transfer taxes. Listed below are brief, incomplete summaries of a few techniques for discussion with your attorney and tax advisor.

A. Gifting Ownership Interests

- Annual gifts valued up to the annual gift tax exclusion amount (\$13,000 for 2009) per donor to each of multiple recipients
- Gifts valued up to the lifetime gift tax exclusion of \$1,000,000
- Gifts of family LLC or family limited partnership interests (the value of the gifted interests are discounted for lack of control and minority ownership, thus permitting gifts of greater percentages of the business within the foregoing gift tax exclusions)
- Gifts of ownership interests in trust to children and grandchildren
- Gifts to children and charity with subsequent corporate repurchase from charity

B. Sales of Ownership Interests

- Installment sale to intentionally defective grantor trust⁹
- Private Annuity
 - Objective – avoid gift and estate tax
 - Structure - ownership interests are sold to active children in exchange for unsecured promise to make payments to seller for the remainder of seller's life or for the remainder of seller and his/her spouse's lives
- Self-Canceling Installment Note ("SCIN")
 - Objective – avoid gift and estate tax
 - Structure - an installment note in which the remaining payments are canceled on seller's death
- Charitable Remainder Trust – seller donates ownership interests to a charitable remainder trust for the benefit of seller (and his/her spouse) followed by a cash sale to the business of the ownership interests; the cash funds the trust to provide retirement income to seller (and his/her spouse) at the same time as reducing seller's ownership interest in the business.
- Grantor Retained Annuity Trust (GRAT) – seller retains the right to receive fixed annuity payments for a term of years or until his death and, at the end of the term, the remaining trust property is either distributed to beneficiaries or held for their benefit. Only the value of the remaining trust property is subject to gift tax.

⁸ On January 12, 2009, the WSJ reported that the current administration and leaders plan to block the disappearance of the federal estate tax in 2010, <http://online.wsj.com/article/SB123172020818472279.html>.

⁹ An irrevocable trust that is recognized for federal estate tax purposes but ignored for federal income tax purposes.