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ESTATE PLANNING

Family Business Succession Planning

FOR USE WITH THE GENERAL PUBLIC

If you're committed to the long-term success of your family business, it's important to make plans now to help assure safe passage of your business to your children.

Tomorrow's security begins today

Making plans for the future success of your business is no easy task. Add family dynamics to the situation, and your job becomes more complicated.

It's important to start making plans for the future of your business. Even if you haven't discussed plans with your family, your silence doesn't prevent your spouse or your children from forming their own expectations. Balancing both your family and business goals may require compromise, planning and communication.

Dealing with the tough issues

Planning allows you to help maximize business assets, minimize transfer taxes and continue the privileges and opportunities of family business ownership.

The tough issues – transitioning into retirement, thinking about making leadership choices among children, letting go of a prestigious position for an uncertain future and ultimately, death – often keep many business owners from making plans.

Still, your business must be run effectively. You need to know if your business is large enough and successful enough to support your family. You need to ask and answer the tough questions. For instance:

- Are you planning to retire or transition to full retirement?
- Can you afford to retire?
- Will you be able to sustain your standard of living during your retirement years without having to rely on your children or the business?
- Who would own your business today if you had died last night?
- Who would run it?

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Balancing business and family interests

Many family-owned businesses struggle to survive beyond a single generation. The complexities of managing overlapping family relationships and business issues can multiply with an extended family and growing business.

Birthright alone is not enough to determine who your successor will be. You should consider a person's qualifications, experience and competence if you want to ensure the continued success of your business. Strategic planning – involving both your business and your family – can help strengthen and extend the business you've worked so hard to build.

Competing interests

In planning your family's role in your company's future, family members will approach the issue from their own perspectives. Some family members may insist that whoever runs the business should be in total control. Others may solicit opinions from all family members and try to build a consensus.

Competing interests may appear when family members debate whose interests should come first – those of the business or those of the family. Should the family's happiness and sense of togetherness come before business concerns? Perhaps the best solution may be a balance between the two.

Active and inactive children

You probably want to treat your children equally when it comes to your estate plan. It is important to keep in mind, however, that equal does not always mean equitable.

The issue of equal versus equitable becomes a major concern when some, but not all, of your children are involved in the business. There is no one right way to plan for succession of your business, given the presence of active and inactive children. There can be, however, a wrong way, which is leaving your business in equal shares to all of your children regardless of their interests and talents. It is possible to treat your children fairly without leaving them the exact same inheritance.

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The ideal solution is to leave the business to the children who are active in the business and assets of equal value to the inactive children. At first glance, this solution sounds obvious, but it's not easy if the business is by far your most valuable asset. From a planning perspective, you should analyze your assets and separate business assets from non-business assets. Then determine a solution to make your estate plan equitable.

Estate equalization through life insurance

Life insurance is an excellent way to equalize the amount of assets distributed to your active and inactive children. The policy proceeds provide cash to be distributed to your inactive children, allowing you to leave the business to your active children.

Succession planning options

What's more important than planning for the continuation of your business? Listed below are options for helping to provide for the succession of your business in the event of death or disability. Your financial professional and tax advisor can assist you in determining which will work best in your specific situation.

Buy-sell agreements

The estate tax value of your business may be established by an enforceable buy-sell agreement. When funded with life insurance, the proceeds provide the much- needed liquidity for your estate. A properly funded buy- sell agreement identifies a buyer and provides a funding mechanism for the future sale of your business, helping to make sure your business stays intact in the event of your death or disability.

Keep in mind that the Internal Revenue Service (IRS) is always interested and somewhat suspicious of business transfers from senior family members to junior family members. The IRS is concerned that you will undervalue your business in an effort to reduce your taxable estate.

To avoid excessive IRS intervention, careful attention must be given to setting an acceptable value for your business. A professional in this area is recommended, as business valuation can depend on a number of factors.

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Redemptions

Often, shareholders in closely held corporations have relatively few sources of liquid funds available since the bulk of their worth is tied up in the business. In some situations, a cash distribution from the corporation, in exchange for some or all of its stock, also known as a stock redemption, could provide liquidity to the estate.

Installment sales

An installment sale can often be the easy answer for passing a business to another family member, without incurring gift or estate tax liability. An installment sale allows you to sell your business to a family member on a payment plan. Not only do they get the benefit of incremental and more affordable payments, you are able to elect to spread out the tax reporting of gain on the sale over the installment plan period, rather than reporting all the gain at once in the year the sale is consummated.

Installment sales provide estate tax benefits as well as income tax benefits. The installment sale is a method of "freezing" your estate by shifting the potential future appreciation in the value of the business to the buyer.

The price fixed upon the date of sale is the value of the business that will be included in your estate, to the extent of any remaining payments still due on the note, without inclusion of the additional growth of the business asset. If the installment note is for the fair market value of the business, with a reasonable interest rate on the note, this transaction will typically be free of gift tax reporting requirements, too.

There are some special rules when installment sales occur between related parties. The rules are complicated, so be sure to utilize your tax advisor when planning an installment sale of your business with a family member.

Installment sales to grantor trusts

An installment sale to a grantor trust can work well for family owned businesses expected to appreciate in value over time, especially when the family expects to have an estate tax problem. The business owner generation (typically a parent or grandparent) sells their business interest to an irrevocable trust in exchange for an interest-bearing promissory note. When properly structured, the sale freezes the business value at the time of transfer for estate tax purposes and removes future appreciation from the parent or grandparent's estate.

During the term of the note, the grantor receives an income stream from the trust. Depending on the arrangement, this can help provide liquidity to the grantor during his or her retirement. This strategy tends to work best in low interest rate environments, as the grantor can lock in the potentially lower interest rates applicable at the time of the sale.

A properly structured trust must follow several tax and legal formalities, so it is important to work closely with tax and legal counsel when implementing this strategy.

Family partnerships

A family partnership creates a structure for owning and managing a business operation, real estate, and other assets. It is an effective estate planning technique because it can be used to shift income taxes from you to your children.

As a general partner, you can keep an ownership interest of as little as 1 or 2%. The rest of the ownership interest can then be gifted to the limited partners – typically your children. This arrangement, if employed properly, can prevent your children's interests from being included in your estate.

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A family partnership lets you retain control over the management of your assets while giving partnership interests to your children. In fact, interests in the partnership may be gifted to your children at a discounted value because limited partners have no control over partnership assets and limited partnership units are generally not readily marketable. The value of partnership assets for gift valuation purposes is typically less than if they were owned outright.

Valuation discounts

Much interest has been generated on the topic of valuation discounts. The value of business interests transferred to various family members may be discounted for non-marketability and minority interests. Discounts are often discussed in conjunction with family partnerships as a way to implement a succession plan, as well as a way to shift income to younger generations.

The discounts will vary depending on the nature of the business, the percentage of transfer industry conditions and general economic conditions among other factors, and the court reviewing the case.

The availability of a valuation discount can translate into significant savings in estate and gift taxes. For example, with a 30% discount, a $1 million family business would be valued at only $700,000. Keep in mind, that there is no guarantee that a valuation discount will be available for any given transfer.

Compensation and benefits for family members

Payroll

You may want to consider placing family members on the payroll to achieve certain tax advantages. If so, care must be taken so that the employee's income is characterized as earned income and not considered a gift from one family member to another.

Properly done, the business receives a tax deduction (for compensation paid) while the family member earns taxable income. The business is not eligible for a tax deduction if the family member does not actually perform services for the company or if the services rendered bear no reasonable relationship to the compensation paid. To be safe, compensation paid to a family member should be in accordance with the prevailing rate of compensation for comparable positions with comparable employers.

Where reasonable compensation does not present a problem, there are other attractive features of placing family members on the payroll. These family members may become eligible to participate in the company's qualified retirement plans as well as other employee benefits.

Children under age 18

Hiring your child can offer certain tax benefits and, assuming the job is legitimate and that the compensation is reasonable for the work performed, your business can deduct your child's salary. Plus, since the kiddie tax does not apply to earned income, your child's income may be taxed in a lower bracket. And, in some situations, Social Security taxes may not be imposed on children under the age of 18.

Benefits

Providing employee benefits for family members who actively work in your business is very much the same as providing benefits for non-family employees. While family members may participate in the benefits offered to all employees, some special benefits may be offered to them as a privilege of being family members.

Fringe benefit plans for key people

Your business may employ one or more key people without whom your business would struggle. Motivating, retaining and compensating these non-family key people becomes vitally important. To keep these valued employees with your company for the long run, special consideration should be given to their fringe benefit plans. Using non-qualified plans allows the owner to offer these special benefits to select employees.

Executive bonus plans

Executive bonus plans are another type of executive fringe benefit. You pay a valued employee a bonus that is tax deductible to the business, and your employee receives a life insurance policy funded to provide retirement income. It is the most straightforward type of fringe benefit and also the most popular.

Custodial executive bonus plans

Custodial executive bonus plans add an element of control for you by allowing you to control the employee's access to life insurance cash values for a stated period of time. With a custodial executive bonus plan in place, you can prevent the employee from using the policy cash values to compete against you.

Split-dollar plans

Split-dollar plans can be offered as a means of compensating and rewarding your valuable key employees. Split-dollar plans can be designed to provide key people with death benefit protection, retirement income or both. Many business owners like split-dollar plans because the plans let them maintain control over their money and recoup it when the employee dies or terminates service.

Supplemental executive retirement plans (SERPs)

SERPs are commonly designed to reward a key employee who stays with your company until retirement or a specific period of time. Designed as "golden handcuffs," SERPs serve as a retention incentive for your key people, officers and executives. You have great latitude in designing the plan so that you retain control of the money until the employee has performed the services required. In the long run, it may even be possible to recover your plan costs.

Review, evaluate and plan

Most successful families have to work to overcome the challenges inherent in passing a family business to the next generation. At least once a year, you and your family should review your company's performance and plans, review your family's plans, and update personal activities and goals. The purpose of early planning discussions is not to solve all of your challenges, but to develop some understanding of the challenges ahead and keep an open dialogue.

The following questions are designed to help you consider some critical business issues.

Succession issues

- How are the founders assured of lifelong financial security?
- How will the founders select the next generation of leaders?
- How will conflicts between generations be handled?
- How will sibling conflicts be handled?
- Are there children in the business who can, and want to, be the successors?

Participation issues

- How do you decide who can join the family business?
- What if a family employee doesn't work out?
- What if a family member chooses to leave the business?
- Are spouses encouraged to participate in the business?
- What happens in the event of divorce?

Compensation and ownership issues

- How do you evaluate and pay family members?
- How do you reward non-family key people?
- What benefits should the business provide?
- Who can have an ownership interest in the business?
- What returns do non-employees/ shareholders expect?

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