



Succession Planning Basics

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What are we going to cover today?

- Just the basics
- From the legal professional's perspective
- Family and closely-held businesses
- Corporate and estate planning issues

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What is Succession Planning?

- Means many things to many people:
 - “Selling” or “Getting Out”
 - Keeping a business “in the family”
 - Retiring

- For Today: Succession planning is the process of planning and implementing the transfer of a closely-held business, while providing the owner and his family with adequate retirement income.



The Process: What is involved?

Four Basic Steps:

1. Determining the client’s business goals, family goals, and financial needs
2. Management succession
3. Transferring the business
4. Estate planning



Step 1 - Determining Goals and Needs: Business and Family Goals

- What are the owner's business and family goals?
 - Does the owner want to keep the business "in the family?"
 - Does the owner hope to sell to management or a third party?
- Understand the facts about the owner's business and family situation:
 - Are any family members involved in the business?
 - Are other family members competent to handle significant assets?
 - Does the owner want to treat all family members equally, or just fairly?
- Are there other part-owners of the business?
 - What are the other owners' goals?
 - Do the other owners intend to purchase the rest of the business?



Step 1 - Determining Goals and Needs: Financial Needs

- What are the owner's financial needs?
- Many business owners have valuable businesses, but few other liquid assets. They need cash flow.
- Can the owner's goals be feasibly accomplished based upon the value of the business?
- Does the business generate enough income to support the owner and the successors (e.g., his or her children)?



Step 2 - Management Succession: Why is this important?

- Many businesses are more valuable than the sum of their assets; they have goodwill.
- The value of the business is dependent on retaining competent management.
- Is the owner's retirement income paid from the profits of the business? If the business fails, the owner doesn't get paid.



Step 2 - Management Succession: Training qualified replacements

- The owner may need to groom his or her replacement:
 - Train interested family members
 - Train existing employees
 - Hire new, qualified managers
- Bring in an outside board to assist while the new managers learn the ropes
 - Caution: Will the board need more training than the owner's successor management?



Step 2 - Management Succession: Retaining the Managers

- After good managers are trained, it will be important to retain them
- Strategies:
 - Employment Agreements
 - Specialized Compensation Arrangements
 - Full or Part Ownership of the Business



Step 2 - Management Succession: Retaining the Managers

- Employment Agreements:
 - Provide termination only for “good cause”
 - Consider including change of control or management continuity provisions (golden parachutes)
 - Subject to tax law restrictions under Code §280G.
- Caution: If the management-continuity provisions are too restrictive, will the agreements depress the value if the owner sells to a third party?
- Caution: Internal Revenue Code (“Code”) Code §409A applies wherever there is a potential for deferral of compensation. Careful drafting is required.



Step 2 - Management Succession: Retaining the Managers

- Executive Compensation Plans
 - Conceptually these are like other retirement plans, but only for key employees
 - Reward management for continuing employment
 - Code §409A generally applies, so careful and knowledgeable drafting is required



Step 2 - Management Succession: Retaining the Managers

- Transferring full or part ownership of the business to the key employees:
 - Stock bonus plans
 - Sale of some ownership directly to key managers
 - ESOP
 - Stock options



Step 3 - Transferring the Business

- Now we will concentrate on designing and completing the transaction.
- This is where many paralegals with transactional practices will become involved in the process.



Step 3 - Transferring the Business: Income Tax Basics

- Seller pays long-term capital gain tax on many assets and certain interests in business entities.
- Seller pays ordinary income tax on interest, rental income, and depreciation recapture.



Step 3 - Transferring the Business: Income Tax Basics

- Buyer deducts interest payments and rental payments.
- Buyer cannot deduct principal payments.
- Buyer gets basis in assets purchased, and can depreciate many types of property.
- Related parties must charge interest at Applicable Federal Rates (published by IRS).



Step 3 - Transferring the Business: Transfer Tax Basics

- Estate Tax:
 - \$3,500,000 per person exemption, integrated with gift tax
- Gift Tax:
 - \$13,000 per person annual exclusion
 - \$1,000,000 per person lifetime exclusion
 - Address this with discount valuations




Step 3 - Transferring the Business: Transfer Tax Basics

- Discount valuations
 - Used to depress the value of a business being transferred, for transfer tax purposes
 - Lack of marketability discount
 - Lack of control discount (minority discount)
- Determined by appraisal



Step 3 - Transferring the Business: Other Relevant Taxes

- Real property transfer tax
 - Carefully check for exemptions
 - State real property transfer tax on certain transfers of controlling interests in business entities with substantial real estate assets
- Uncapping issues
- Etc.




Step 3 - Transferring the Business: Common Types of Business Transfers

- Sales:
 - To other owners
 - To all employees (ESOP)
 - To key employees
 - To family members

- Gifts

- Combinations of both



Step 3 - Transferring the Business: Sales to Other Owners and Key Employees

- Where a business has multiple owners, do the owners want to purchase each other's interest in the business on death, disability, or retirement?

- Buy-Sell Agreements
 - Triggering events
 - Valuations
 - Funding



Step 3 - Transferring the Business: Sales to All Employees

- Employee Stock Ownership Plan (“ESOP”).
- A qualified pension plan in which employees are participants.
- The ESOP purchases the owners stock.
- Under Code §1042 the owner can reinvest the sale proceeds in certain publicly-traded securities while deferring taxation on the sale of the his or her shares.



Step 3 - Transferring the Business: Installment Sales [Code §453]

- Owner sells all or part of the stock or assets of the business to the next generation of owners.
- Sale is for fair market value (determined by an appraiser in family situations).
- Buyers pay the purchase price over time under a promissory note, with interest. This give the seller a stream of retirement income.
- Seller realizes income tax as payments are received.
- Caution: This special tax treatment does not apply to inventory, depreciation recapture, or certain sales of depreciable property among related persons.




Step 3 - Transferring the Business: Gifts

- Owner may gift assets or business equity interests (e.g., stock, LLC membership, partnership interests) to children
 - \$13,000 annual exclusion gifts
 - \$1,000,000 lifetime gift exclusion
- Many variations on types of gifts
- Opportunities for valuation discounts



Step 3 - Transferring the Business: Self-Canceling Installment Notes

- Variation on installment sale.
- Owner can all or part of the sell stock or assets of the business.
- Buyer gives owner a promissory note to pay the purchase price, which states that any remaining payments terminate upon the owner's (or the owner's spouse's) death.
- The owner must receive a higher interest rate or larger purchase price.
- Unrecognized capital gain is recognized on death.



Step 3 - Transferring the Business: Part gift and part sale

- Owner may gift some equity interests in a business, and sell other equity interests.
- Avoid having a prearranged, binding agreement to transfer all interests to preserve valuation discounts.
- These “two stage” transactions are common.
- Owner and spouse may gift using annual exclusions and lifetime exclusions, and children may purchase the remaining interests.



Step 3 - Transferring the Business: Types of interests

- Give business interests only to children who are actively involved.
- Give voting interests to children who are actively involved, and nonvoting interests to those who are not involved.
- Give actively-involved children or the business entity a call option or redemption rights.



Step 3 - Transferring the Business: Salary Continuation Agreement

- The owner will receive a series of payments following retirement (e.g., following the sale).
- Taxable income to the owner upon receipt of the payments.
- Immediate payroll taxation on the actuarial value of the benefit, but Social Security's Old-Age, Survivors, and Disability Insurance ("OASDI") annual compensation limit applies [\$102,000 in 2009]
 - Applies to actuarial value
 - The owner and business pay tax on the Medicare portion
 - The owner and business may pay no additional OASDI
- Liability that decreases the value of the business.



Step 3 - Transferring the Business: Grantor Retained Annuity Trusts

- GRAT is an "estate freeze" technique.
- Owner transfers stock to an irrevocable trust, and retains an annuity based upon the value of the trust assets.
- The remainder (if any) is paid to his or her children.
- The present value of the remainder is a taxable gift.



Step 3 - Transferring the Business: Grantor Retained Annuity Trusts

- The owner's annuity is based upon IRS applicable federal rates, so that the present value is zero (no taxable gift).
- The GRAT is structured as a "grantor trust" for federal income tax purposes.
- Use a series of GRATs.
- Sanctioned under Code §2702.



Step 4 - Estate Planning

- Estate planning is integrated with many transactions we discussed today.
- Important to ensure that other (non-active) descendants are treated fairly.
 - Leave other assets
 - Life insurance



Case Study 1: Dairy Farm

- Mom and Dad own a dairy farm in southwest Michigan
- The farm is conducted through a single-member LLC that Dad owns, and includes:
 - **farm equipment** (worth \$200,000, with a low basis)
 - **cattle** they raised (worth \$250,000)
 - **200 acres** are tillable crop land (worth about \$1,000,000)
 - **20 acres** include the dairy, a milking parlor, barns, and Mom and Dad's residence (worth about \$300,000)
- They also own a fruit farm on Old Mission Peninsula worth \$750,000, and have \$500,000 in other assets



Case Study 1: Dairy Farm

- They have two children: Son and Daughter
 - Only Son is involved in the dairy farming business, and he wants to purchase the dairy farm.
- Mom and Dad do not have federal estate tax concerns because their gross estate is \$3,000,000, which is less than the \$3,500,000 estate tax exclusion amount.
- Accordingly, a sale may be an effective way to transfer the farm assets to Son.



Case Study 1: Dairy Farm

- Proposed Plan:
 - Train Son
 - Installment sale for the farm real estate and dairy cattle
 - Lease the equipment or purchase it piece by piece to prevent immediate taxation
- Values?
 - Get appraisals!
- Provide for Son and Daughter equally in their estate plan.



Case Study #2 – Fruit Farm

- Mom and Dad own a fruit farm in the northern lower peninsula.
- The farm is conducted through a multi-member LLC that they own 50% each, and includes:
 - **farm equipment** (worth \$25,000, with a low basis)
 - **450 acres of orchards, including approximately 1,500 feet of Lake Michigan frontage** (worth about \$4,500,000)
- They also have \$3,000,000 in other lake front real estate (which is their home farm, of about 40 acres), and \$500,000 in liquid assets.



Case Study #2 – Fruit Farm

- Mom and Dad have two children: Daughter and Son.
 - Only Daughter is involved in the fruit growing business. Daughter wants to acquire the 450 acre farm.
 - Son would like to receive some lake front property as her inheritance.
- Mom and Dad have a gross estate of \$8,200,000, and accordingly, require estate tax planning.
- They are “farm rich, cash poor” and don’t have enough liquid assets to simply stop running the business and retire. They will need income of \$150,000 per year for 25 years.

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Case Study #2 – Fruit Farm

- Proposed Plan
 - Train Daughter.
 - Obtain discount appraisal for a minority interest Farm LLC (assume a 30% discount).
 - Mom and Dad each gift Daughter a 10.5% membership interest in the LLC (valued at \$660,000 total).
 - Several months later, Daughter will purchase all remaining interests in an installment sale for \$2,490,000. At 3.52% interest (the May 2009 AFR), Mom and Dad will receive \$12,500 per month.

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Case Study #2 – Fruit Farm

- Mom and Dad will have reduced their gross estate to approximately \$6,000,000, which is less than their remaining combined exclusion amount of \$6,340,000.
- At a 45% tax rate, this is a tax savings of \$600,000.
- They will have adequate cash and real estate to make equitable bequests to both Daughter and Son.

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Thank you!

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