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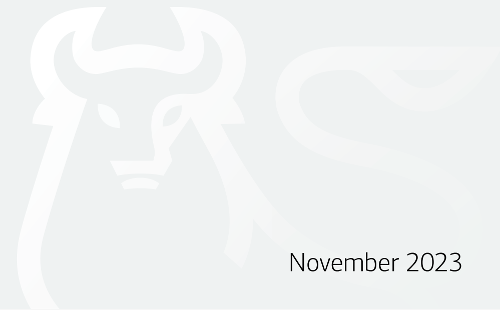

CHIEF INVESTMENT OFFICE

Wealth Strategy Report

Business Succession Planning

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One of the important decisions a business owner must face is when and how to step out of the business – in other words, business succession planning. Do you expect to retire from your business? Do you have a plan in place? What would happen to your business if you were to die today? Do you have children you hope to bring into the business? These are questions only you can answer, and your answers will lead you and your financial and legal advisors to a course of action.

THE CHOICES

There are a few basic alternatives.

- Lifetime Gift/Sale to Your Family. If your family is involved in the business, you could give or sell your business to them.
- Sale to Non-Family During Your Lifetime. If your family is not involved in the business, you could sell the business to a non-family member when you are ready to move on.
- Gift/Sale Upon Death. If you are not ready to retire, you could simply provide for the sale or distribution of your business upon your death.
- Sale to Co-owners. If you co-own the business with others, you could enter into an agreement with them to sell your business interest upon the occurrence of one or more events.

If you actively manage the business, you should also make sure to have a plan in place for one or more persons to take over the management of the business if you are unable to act.

Remember, in most cases the question is not whether or not someone else will succeed to your business. Rather, the question is whether you address these issues now or burden someone else with them down the road.

LIFETIME GIFT/SALE TO YOUR FAMILY

During your lifetime, you can transfer your business to one or more family members by gift or sale, or a combination of both. These transfers may be motivated by your desire to transfer the control or the economic benefit of the business to your family members, or they may be motivated by your desire to minimize your family's exposure to the

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federal estate tax. You may transfer the business to your family over time, or all at once at your retirement.

Below are some issues to keep in mind when gifting or selling your business to family members.

Control, Ownership & Management of Business

If you want to transfer the business to your family, you need to determine (1) who will control the business, (2) who will own the business, and (3) who will manage the business. If you want to retain control of the business but transfer some or all of its economic benefits, you could transfer a non-voting interest. If only one of your family members is involved in the business, you might want to transfer a voting interest to him/her while transferring non-voting interests to the others. In this manner, all family members are owners of the business, yet the control remains with those family members involved in the business. You must also decide who will manage the business, whether it is family or non-family members. The control, ownership and management of the business may be held by the same individuals or different individuals.

Gift/Estate Tax Exposure

Lifetime transfers of your business may benefit your family by reducing the federal estate tax due at your death. Gifts you make during your lifetime can reduce the value of your taxable estate. However, it is important to structure these gifts in a manner that avoids the federal gift tax as much as possible. Annual exclusion gifts ($17,000 a year per donee in 2023; $18,000 in 2024) remove property from your taxable estate without generating any gift tax or using up any of your lifetime gifting exemption ($12,920,000 in 2023; $13,610,000 in 2024). You may want to consider establishing an annual program of transferring a small percentage of your business to your family members to take advantage of this exclusion. Over time, this could greatly reduce the size of your taxable estate.

Gift Appreciating Property

Lifetime gifts of appreciating property, even gifts that use up some of your lifetime exemption, can reduce the federal estate tax because the future appreciation is removed from your estate. Therefore, if your business is appreciating, you should consider transferring at least a portion of it to your family now rather than waiting to transfer a much more valuable (and more heavily taxed) business through your estate.

How to Gift

Gifts of your business can be made directly to your family or to one or more trusts for their benefit. Various trusts may be used, each providing its own benefits. Transfers of minority interests or otherwise restricted interests in the business can also help reduce federal estate and gift taxes. This is because the transfer taxes are imposed based on the fair market value of the interests transferred. If you transfer a business interest that is eligible for certain valuation discounts, such as for lack of control or lack of marketability, you will generate less gift tax (or will need to use less of your lifetime gift tax exemption).

Freeze Current Value of Business

If you want to transfer your interests to your family during your lifetime but don't want to do that by gift, you could consider selling all or a portion of your business to your family. You can transfer the control or economic benefit of the business, and arrange for immediate payment or for payment on an installment basis.

Such a sale can provide estate tax benefits by "freezing" the current value. For example, if you sell the business for an installment note that bears 3% interest annually, and if the value of the business thereafter appreciates in excess of 3% annually, you have "frozen" the value that you own (and which is exposed to estate tax), with future appreciation in excess of the 3% accruing outside of your taxable estate.

SALE TO NON-FAMILY

When it comes time to sell your business, there are several items to consider.

Determine its Value

This will usually involve an appraiser who will use some methodology (for example, an income approach, a market approach or an asset approach, or some combination of those) to arrive at the value of the business.

Locate a Buyer

Potential buyers could be found through a business broker or perhaps through a competitor within your industry. Buyers could include competitors, the senior management of your company, family (as discussed above), or your employees directly or through a tax favored structure like an Employee Stock Ownership Plan (ESOP).[1] In any event, the buyer must be able to finance the deal.

Sale for Cash, Stock or Both

Your business may be sold for cash, stock in the acquiring company, or both. Each approach carries with it advantages and disadvantages, such as risk, liquidity, current or deferred tax liabilities, and influence on the new entity.

Tax Consequences

You will want to consider the tax consequences, whether a direct sale, stock for stock transaction, installment sale, ESOP or other. For example, a sale for cash will almost certainly result in current taxation of any capital gain, while a stock-for-stock exchange can usually be structured to defer taxes until the newly acquired stock is sold at some future date.

Continued Involvement in Business

You will need to decide if you are willing to stay involved in the management or operation of the business after the sale or to sign a non-compete agreement with the purchaser.

[1] We have a separate Wealth Strategy Report: *Section 1042 Rollover of ESOP Sale Proceeds.*

Post-Sale Ownership

If you receive stock in the acquiring company, then depending on your position in the new entity and the manner of sale, you may need to plan for regulatory, risk management and asset diversification issues specific to the stock received.

Pre-Sale Wealth Transfer Planning

The way you structure the sale of your business is very important. You may be able to reduce the amount of the sale proceeds that are included in your estate by implementing certain estate planning techniques prior to the sale.

For example, if you transfer interests in the business to your family members in a tax efficient manner prior to the sale, the proceeds from those gifted interests will pass to the family members rather than to you. If the business appreciates in value between the date of the gift and the eventual sale, you also will have removed the appreciation from your estate. Of course, the closer you are to the sale date, the less appreciation is likely to occur. Remember, no matter which options you choose, you should do so in consultation with your legal, tax and financial advisors.

These issues are discussed further in our separate Wealth Strategy Report: *Sale of Your Closely-held Business*.

GIFT/SALE AT DEATH

Sale of Business

In case you do not dispose of your business during your lifetime, your estate documents should address what happens, whether that is to instruct your executor to pursue a sale or to continue the business.

Transfer Business to Family

If your family wishes to carry on your business, or just benefit from its ongoing operation, you should provide for the appropriate transfer of the business in your estate planning documents. This may involve transferring a controlling interest in the business to certain beneficiaries, while others receive a non-controlling economic interest only. Alternatively, you may want to provide for the business to pass to certain beneficiaries, while other beneficiaries receive the remainder of your estate. If this would result in an unequal distribution, you may require the beneficiaries who are involved in the business to buy out the other beneficiaries, perhaps on an installment basis or you may want to utilize life insurance to "equalize" your estate among your heirs.

Your family will face the same estate tax as do the families of non-business owners. Even with proper estate planning, certain estates with interests in closely held businesses do not have sufficient assets outside of the business to pay the estate tax. If you are concerned about this possibility, you may want to obtain life insurance for the purpose of providing your estate with cash to pay the tax. Note that if the life insurance is held by a properly drafted Irrevocable Life Insurance Trust (or ILIT), the proceeds themselves will not be included in your estate, and therefore will not be subject to estate tax. You should consult with your estate planning attorney to determine how to coordinate the creation and funding of an ILIT with your other estate planning strategies and lifetime gifting.

The federal estate tax also has several provisions aimed at softening the estate tax burden otherwise imposed on some small business owners in order to prevent forced liquidations of family businesses.

1. For example, certain estates that hold qualifying interests in closely held businesses may pay the estate tax caused by that closely held business over a 14 year period (with interest, of course), rather than by the normal 9 month deadline.
2. Another provision would allow a qualifying estate to redeem its stock in a closely held corporation to pay taxes and estate expenses, with the redemption treated as a sale even if it would normally be taxed as a dividend.
3. For an estate that holds real estate in a family business or farm, the estate may be allowed to elect to have that real estate valued based on its actual use in the business rather than on its higher potential development value.

Being aware of these tax provisions may enable your estate to qualify for their benefits if you take the appropriate steps to meet their requirements. If you determine with your estate planning attorney that your estate would qualify, you must also make sure you don't unwittingly take any action that jeopardizes that qualification. These provisions are discussed further in our separate Wealth Strategy Report: *Special Estate Tax Provisions for Business Owners*.

SALE OF BUSINESS TO CO-OWNERS — DEALING WITH THE 5 "DS"

Every business owner has to deal with the 5 "Ds": Death, Disability, Divorce, Departure or Default. If you are the only owner of your business, these matters are relatively straightforward. You can deal with your death through your estate planning documents, as discussed above. You can deal with your disability by specifying a representative, for example an attorney-in-fact or successor trustee, to make your financial decisions, including ones involving your business. You can deal with your potential divorce through a pre-or post-nuptial agreement. You can deal with your departure by giving away or selling your business. You do not have to deal with default, as you cannot default against yourself.

If you co-own your business, dealing with the 5 "Ds" can be much more complicated. In many situations, if one of the 5 "Ds" occurs to you or to one of your co-owners, the best alternative for the company and its owners may be to buy out the affected co-owner. If the company is the purchaser, this is called a "redemption." If the other owners are the purchaser, this is called a "cross purchase." If such a buy-out occurs in a timely and equitable manner, the possibility of adverse consequences (e.g., disruption of operations, entity dissolution or acquisition by outsiders) is greatly diminished.

Buy-Sell Agreement

A buy-sell agreement is a crucial planning tool that establishes when, to whom, and at what price an owner, partner or shareholder can or

will sell his or her interest in a business. A typical buy-sell agreement allows and/or requires a business or its owners to purchase a departing owner's business interest at a predetermined price (often determined by formula). Each buy-sell agreement is tailored to the needs of the particular business and owners, but the eventual purchase price (or formula) should be included. This way, the major sale negotiation is conducted at a time when there is no pressure to sell or buy. This eliminates the need for a fire sale when you retire, become ill, or die, and prevents a bidding war with outsiders.

You should consider the use of a buy-sell agreement if you:

- Do not want to be forced to work with or share control of the business with a stranger or a spouse or other family member who buys an interest from a departing owner;
- Do not want your heirs to be forced to work with or share control of the business with a stranger or a spouse or other family member of a deceased or divorced co-owner;
- Do not want to end up co-owning the business with a bankruptcy trustee or creditor if a co-owner experiences personal financial difficulties;
- Do not want your heirs to inherit a business for which they cannot get a fair price;
- Do not want to engage in pricing disputes with heirs of deceased co-owners

There are several advantages to establishing a buy/sell agreement. It can ensure that no interest passes to an owner in a manner that could disqualify the entity for any tax benefits (this can be particularly important if your business is structured as an S Corporation). Such an agreement can provide assurance to creditors, customers and employees that the business will remain viable under all circumstances. It can also prevent an outsider, divorcing spouse or creditor from gaining control of the business.

Perhaps the most important advantage of a buy-sell agreement is that it can guarantee a buyer for a departing owner's interest. There is often no market for the sale of a closely held business, which could make finding a buyer difficult. Some assets, such as equipment, may have a specialized use or a short time frame of technological usefulness. Factors such as the type of business (services vs. manufacturing), level of competition, the size of the business overall and the proportion that your interest in the business represents (majority vs. minority) can affect the ability to find a buyer with sufficient cash or access to sufficient financing to buy your interest.

A buy-sell agreement can also provide many advantages with respect to your estate plan. If structured properly, it can establish the estate tax value of the business, and thereby minimize valuation conflicts with the IRS at your death. It can also protect your heirs from unfair treatment. For example, when the sale occurs after your death, your family or estate may be at a distinct disadvantage when negotiating with a potential buyer. The interested buyer might try to take advantage of your family's need for cash to pay your estate expenses and might offer a price that is below a fair market value. A buy-sell agreement helps to ensure that your estate will get a fair price and have the liquidity to pay expenses, including the estate tax.

The primary disadvantage of a buy-sell agreement is that it reduces the control the business owner has over his or her interest. Depending on whether your agreement contains a "right of first refusal" type provision for a sale other than one triggered by specific events (e.g. death, retirement at a specific age, etc.), you may not be able to sell or give your business to anyone except the buyer named in the agreement without the buyer's consent. This could restrict your ability to cash out your interest in the business. It could also limit your ability to reduce the size of your estate through lifetime transfers of your business interest, unless you carefully coordinate the terms of your buy-sell agreement with the rest of your estate plan.

For a buy-sell agreement or any other planned sale of the business (for example, an equalizing buy-out of your business by your actively participating family members from the other beneficiaries of your estate) to be successful, financing must be available to fund the eventual purchase of the business interest. Without a funding plan in place, the buyer(s) may be forced to sell assets, take out loans or even file for bankruptcy. Sometimes the cash flow of the business will be sufficient to cover any funding needs, and other times borrowing may be required. Another alternative is insurance. If you become disabled, disability insurance might help the company fund your buy-out. Upon your death, life insurance held by the company or your co-owners can finance the purchase of your business interest from your estate. Remember, if insurance is your preferred method of financing, care must be taken to maintain the appropriate coverage.

— National Wealth Strategies, Chief Investment Office

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