Business Succession—Planning for Future Generations

by Roy C. Goldberg, CFP®, CLU®, ChFC®, CASL®, RHU®

Help clients with their business succession plans by laying out all the options.

BUSINESS LIQUIDATION IS A typical result of a failed business succession plan. The main issue of business succession is the development of future leadership and how new management will cash out the current owner's business capital. Will the next generation have entrepreneurial skills and management talent? As financial advisors, our responsibility includes motivating the owner to take action in transferring and protecting wealth. Our role includes minimizing business conflict, keeping peace in the family, and avoiding unnecessary delays and procrastination.

The biggest threat to business succession planning is procrastination and the failure to have a plan.

That means helping clients weigh the business transfer options (see Table 1 on the next page):

- Sell during lifetime
- Sell at death
- Gift during lifetime
- Gift at death
- Employ freezing techniques in combination with other vehicles for a future transfer of wealth

Succession Planning is about the future; the unquantifiable wild card is developing new leadership, transferring management and ownership, while minimizing taxes on both generations.

Business succession can be viewed from one of three basic methodologies:

1. The stakeholders within succession planning
2. The prospects and their valuation channels
3. Three levels of business transition planning

THE STAKEHOLDERS

In addition to the bank, which could be considered another entity that may demand a seat at the business succession table, the following stakeholders will potentially be present:

- Founder or current leader
- The family
- The business entity or activity
- The management
- The ownership interests
- The owner's estate

Using questions to uncover information and identify conflicts is encouraged by Charles Fox, Esq., Senior Partner heading the estate planning section of McGuire Woods Law Firm of Richmond, Virginia, and Adjunct Professor of Law at the University of Virginia in Charlottesville. This education is the core strategy in avoiding procrastination because the owner can respond to each problem one at a time and develop confidence

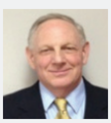

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TABLE 1

Sales Strategies	Installment Sales Private Annuities Self-Canceling Installment Notes or SCIN Buy-Sell Arrangements
Freezing Techniques	Grantor Retained Annuity Trusts (GRATs) Installment Sales to GRATs which become defective for income tax purposes or Intentionally Defective Irrevocable Trusts (IDIT)
Gifting Techniques	Annual Gift Exclusions, Lifetime Exemption, Gifts in Trusts, such as: CLATS, CLUTS, CRTs(Charitable Remainder Trust), Direct Gifts, or Bequests at Death
Using Life Insurance as a Flexible Funding Mechanism and as a Tactical Tool	Combination Wealth Replacement Trusts (ILIT) with CRT, etc. Estate Equalization and Estate Liquidity Funding Buy-Sell Arrangements Funding Nonqualified Deferred Compensation Plans to retain talent and for retirement planning Key Man Insurance to replace management talent Wealth Replacement Trust Funding vehicle (such as an ILIT) Disability Buy Out Protection Do you want Guaranteed Death Benefit? How important is accumulating cash value either for supplemental tax- free retirement income, tax deferred capital accumulations, collateral for loans or on the balance sheet, or for estate planning flexibility? How important is Guaranteed Cash Value versus other forms of cash value accumulation? Do you need Permanent Protection or just temporary Short-term Protection? Split Dollar Insurance Premium Financing

in areas in which he is not an expert. Consider the following questions:

- Should the business be liquidated or sold during the owner's lifetime or should it be continued?
- Who will own the business after the succession plan for the business is executed?
- Who will control the business after the change of ownership?
- Is there a plan to develop new management and ownership?
- Is management and ownership unified?
- Will the owner's children be treated equally in the distribution of the estate either in life or at the owner's death? How will that be accomplished?
- What provisions will be made for the present owner (and the spouse) after the business transfer? How will the cost of this ownership change be financed? Have provisions been arranged to minimize transfer, capital gains or estate taxes?

The question approach forces the owner to listen to himself and think through the issues. Asking questions and listening is critical to advice giving. Data collection is essential for the business owner to make decisions and have the courage for change without unnecessary delay.

PROSPECTS AND VALUATION CHANNELS

Another way to start business succession planning is to identify potential buyers and the respective value for each prospect. Establishing a reasonable valuation may determine which techniques are viable. Some delays may start as a rational strategy for the owner because some things do take time to evolve. Exit and retirement strategy are both dependent upon the owner's need for income from the sale of the business. Current low interest rates cannot be used when the value of the business has fallen or when credit is just not available. The price of the business that is inherited or bought by a child is usually very different from outright sale. The motives for selling to a child might necessitate a lower price or a combination gift with a sale and then adding some form of estate equalization among the children. Unlocking that value would be very different from the value placed upon a business that was transferred by an installment sale to a management group. Table 2 explains the typical potential buyers and associated methods of sale and valuation issues. Note that IPOs and

TABLE 2

Channel or Prospective New Owner	Planning Issues, Transfer Methods, & Techniques	Valuation Issues
Family	Gifts, Installment Sales, Bequests at death, Freezing Techniques such as: GRATS (Grantor Retained Annuity Trust) , Intentionally Defective Trust, Spousal Lifetime Access Trust (SLAT), ILIT (Irrevocable Life Insurance Trust or *Wealth Replacement Trust)*, Transfer Techniques include: Private Annuities, Self Canceling Installment Notes (SCINs), Family Limited Partnerships, Buy-Sell Arrangements-entity stock redemption, cross purchase, or hybrid arrangements.	Valuation Discounts for control and minority positions. AFR Rates and general Interest Rates, Splitting of Control & Beneficial Interests of the company, How long the transition process takes. How soon will the transition take place? Quality of Management Non-Quantifiable Family dynamic issues & pressures
Employees	LBO, ESOP, Appreciation Rights, Installment Sales, Stock Options	Negotiated Valuation, or 3rd Party Appraisal Value using Formulas or Book Value
Partners or Co-Owners	Buy-Sell, Options, Warrants, & Rights of First Refusal, Installment Sales & Management Buy-Out	Funding Issues, Book Value, Fringe Benefits, Key Man Issues, Long Term Vesting, Owner's valuation versus market value
Outsiders owner retires or owner continues	Consolidation-Rollups, Outright Sale, Recapitalization, or Merger	Negotiated Valuation, or 3rd Party Appraised Value at arms length valuation
Charitable Trusts	Charitable Lead Trust, Charitable Remainder Trusts, Combined with ILIT *(wealth replacement trust)*	Fair Market Value or Book Value

Gifting Strategies are coded in red
Sales Strategies are coded in green
Freezing Techniques are coded in purple
Other techniques are in blue
Some tools and techniques can be designed for multiple transfer strategies

going public are not an option for the smaller or closely held corporation (see Table 2).

There are a number of questions to consider in valuing a business for the purpose of selling it:

- What will the IRS accept?
- What might an owner accept?
- What would a buyer offer?
- What is the adjusted book value? Is that the best formula?
- What is the liquidation value?

A written Buy Sell establishes the method of valuation, which should reduce IRS challenges, and the document codifies what the rules are should the owner die or becomes disabled. Understanding the valuation choices enables the owner to better select the transfer value and take action.

THREE LEVELS OF BUSINESS SUCCESSION PLANNING

Julius Giarmarco, JD, LLM, an estate-planning attorney in the Detroit area, views business succession planning differently. He suggests three levels of planning:

1. Planning for changes in management.
2. Planning for changes in ownership.
3. Reducing and financing transfer taxes.

This approach is still concerned with new leadership, transferring management and ownership while minimizing taxes on both generations. Ownership can be separated from management perhaps by having both voting and nonvoting stock. In a partnership entity, the difference would be the general manager as compared to the limited partners. In a trust situation, the trustee occupies the control role, and the beneficiaries occupy the economic interest position. As our client becomes educated, he or she becomes more comfortable with taking action.

PLANNING WITH LIFE INSURANCE

Life insurance is a common planning tool because it is a flexible financial instrument. The ability to customize each plan and the capacity to select the payer makes life insurance popular. Arrangements include collateral assignment of the cash values or the death benefits and the ability to have split funding provisions (premium financing, corporate or individual financing, family, bank, or private split dollar, etc.). In this way, choices are tailored to each client.

The capacity to predetermine how long the insurance premiums will be paid or how long the death benefit lasts (term or permanent), and whether to accumulate capital inside the tax advantaged cash value of life insurance enables risk management and certainty to be built into each plan.

The biggest threat to business succession planning is procrastination and the failure to have a plan. Life insurance is a major tool to create an affordable funding vehicle to pass the business skills and the family wealth to the next generation for pennies on the dollar and in a tax-efficient manner.

LOW INTEREST RATE ENVIRONMENT

The current low interest rates make some transfer vehicles more advantageous than others. With the applicable federal rate (AFR) near historic lows, GRATs become quite interesting. The AFR is an integral part of the technical design of split interest trusts. Estate-planning techniques that involve some form of an installment sale between the members of the family or intra-family loans are likely to benefit. Techniques such as private split dollar or family premium financing take on more value because the low interest rates help avoid gift tax issues. Furthermore, clients who consider charitable arrangements can benefit from low interest rates, too. If the transferred assets appreciate at a faster rate than the AFR, that difference is tax-free growth transferred tax free to the next generation. This freezing technique gets future growth out of the current generation's estate.

CAUTION, LIMITATIONS AND DUE DILIGENCE

An inexperienced attorney or lack of coordination with a client's other affairs can result in poor execution of the plan and, perhaps, a lawsuit. Common errors might include the selection of the wrong valuation method or choosing the wrong successor. Not adequately separating management issues from ownership issues is another potential trap. The use of an experienced attorney is the best safeguard against expensive mistakes. The main theme is that a team approach is good for the client, and expert legal advice is inexpensive in the long run if the client's goals are met.

Helping our clients avoid delay is part of our responsibility. Business succession is not easy or smooth, but the process provides clarity so an owner will make a proactive decision to continue the business or face the alternative of selling or liquidating the business on terms more favorable than a forced liquidation. We earn our trusted position by helping the client take educated action and avoid procrastination, which leads to healthy families and capital preservation from generation to generation.