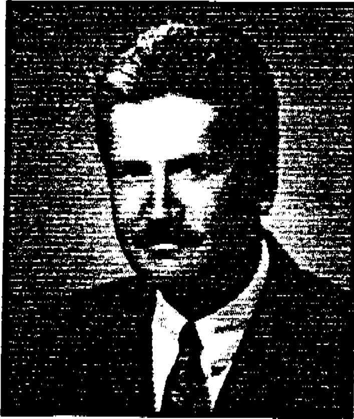

Succession Planning for the Closely-Held Business Owner

by Bryan Goetz
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"Semper Paratus". For decades, this motto has instructed the Boy Scouts of America to always be prepared. As a result, many Scouts have enlisted the help of the Swiss Army knife. A mainstay in many a Boy Scout's backpack, this compact instrument has long been used to solve camping's many unforeseen problems. Open a can, dig a hole, cut wood, unscrew a cork, clean a fish... In short, the Swiss Army knife allows the Scout to prepare for the unforeseen.

Succession planning for a family-owned business is no camping trip, but it, like camping, requires that the business owner prepare for the unexpected. A formal succession plan is the business owner's Swiss Army knife: it forces the owner to prepare for the many issues involved in this crucial transition.

Unfortunately, establishing a successful succession plan is not as easy as making a trip to the local sporting goods store. Likewise, implementation of the plan is not as easy as putting the knife in your back pack. This might explain that while about 50% of family business owners want the next generation to manage and own the business, only 30% of family-owned businesses actually continue to the second generation and only 10% continue into the third. Obviously, there is a gap between succession desires and succession realities. This gap can, at least in part, be explained by a lack of preparation and implementation.

Lack of planning for a successor in a closely-held business is one of the most prevalent mistakes of a business owner. Excuses for not planning or implementing a plan for succession include; "I don't have the time", "Nobody else can run the company", "I don't plan on dying in the near future (or ever)", and "I can't afford to groom a successor". "Can't my business own itself?", is another question that suggests that owners assume that the business will simply keep going without any planning. These excuses become lame, however, when compared to the damage that can be done by not planning for succession.

As a business appraiser, I have seen all too many times when a business owner has died and left nobody as a successor. The family is forced, in a time of great emotional distraught, to find a way to keep the company going. Offers to buy the company at firesale prices may come in, clients may go to competitors fearing a possible loss of a reliable source of product or service, and creditors may try to exert greater control. The value of the company, due to the loss of a key man, may fall precipitously. And since the largest portion of a business owner's estate is normally the business, the family must find a way to pay estate taxes.

Succession planning is crucial to the long-term viability of a closely-held business. By establishing and implementing a formal plan, owners can greatly enhance the long-term success of their business for future generations. This article highlights the succession planning process, its pitfalls and some of the many options available to business owners.

The steps to effectively "pass the baton" to a successor are simple: Determine the successor, establish a plan to transfer control and ownership, and implement the plan. However, each step can be fraught with problems.

Determining a Successor

Essentially, the business owner has three options in determining a successor. He can appoint a family member to run the business, he can hire a manager from the outside or he can sell the business. This determination should be made by weighing the ability of the family members to manage the business, the availability and cost of capable

outside managers, the market value of the business and the goals of the family.

Family Successor

Most business owners' first inclination is to name one of their children as the successor. If one child has clearly stepped to the forefront by taking a leadership role in the business and is obviously qualified to run the business, determining which child to select can be straight forward. If this is not the case, and two or more children have potential, the decision is much more difficult, made more so due to the emotional element of the decision. In years past, the successor would often be the eldest son of the business owner. However, experts and enlightened business owners now realize that the best successor is the one that is most able to bring financial success to the business and achieve the family's goals. This person may be any one of the children, a son *or* a daughter, depending on their education, experience and personality.

The difficulty of this important decision can cause the business owner to delay by designating a group as potential successors, with the best to be chosen later. The drawback to this approach, however, is that, in the case of an unforeseen loss of the owner, the family is in almost the same situation as if no planning had been done. A delay in selection, can also arise from the owners belief that nobody can run the business as well as he or she. This may or may not be true. The idea, however, is not necessarily to appoint someone with the experience and ability of the current owner, it is to find the best person that would most successfully run the business in the event of the loss of the current owner. Assuming one of the children is willing and able to run the company, the decision should be made as soon as possible.

Role of Other Family Members

After deciding which of the children is best suited for running the company, a decision must be made regarding the role of the other children. Despite coming from the same gene pool, siblings tend to behave very differently. Some may be great in the sales side of the business, while others may do better in the production area or financial end. The strengths of each family member should be utilized in the position they fill. It doesn't do any good to try to place a square peg in a round hole. Likewise, there are times when a family member has no place in the business. If a family member cannot perform a job as well or better than someone outside the family, he or she should not be employed by the business. Many businesses have been ruined by too many family members being involved when workers outside of the family would do a better job. A job in the family business should not be a right, it should have to be earned.

Once the successor is chosen and the roles of the other children are determined, the owner should announce his or her intentions to the family. This announcement makes everyone's role very clear and also gives credence to the successor.

Family Compensation

Another issue is how much family members are compensated. Many family owned businesses pay family members above what would be paid to a non-family member. Most experts believe that this is a mistake. This can cause resentment among other workers and often encourages the family member to live a lifestyle above his or her skill level. If a downturn in the business, or other reason, causes this person to have to work for another company, his or her pay will decline. If family members must be compensated at a level above their skill level, it should be in the form of a bonus at the end of the year, based on performance of the company. In this way, it is not assumed to be a given.

Outside Successor/Sale of Businesses

In some circumstances, no family member can, or is willing to, be the successor. In this case, the business owner has two remaining options. He can bring in a manager from the outside or sell the business.

Most often, the family will be better off financially if someone is brought in to run the business, assuming a capable manager can be found. Buyers of businesses demand fairly high rates of return on investment, meaning they often will pay less for a business than the family believes it is worth. Keeping the business can provide income to the family for generations. If a successor is brought in from the outside, his or her authority should be clearly delineated. The successor manager should know when his or her authority ends and the family's begins. Compensation should be tied strongly to performance. As most families won't want to give an outside successor an equity interest in the business, financial incentives are usually needed to produce high level results.

However, families often don't want the headaches of supervising a manager and making other business related decisions. In this situation, an outright sale is the logical choice. A sale of the company can be made through a

business broker or investment banker. He or she will actively market the company, usually taking a percentage of the selling price as a fee. Often times, competitors are the logical purchasers of businesses. Obviously, upon the sale of the family business, the issue of succession becomes moot. The business owner, however, must then tackle the issue of what to do the sales proceeds.

Regardless of which option the business owner chooses, the decision should be made well before the owner intends to retire or limit his or her involvement. First of all, it often helps to groom the successor while the business owner is still active in the business. This gives the successor hands on training and confidence and also allows the business owner to evaluate the successor's performance. Secondly, it is important that a successor be named early on in case of an unforeseen death or disability of the owner. In the case of a sale, it can often take years to find the right buyer for a particular business. Planning well ahead increases the probability of receiving the maximum price.

Establishing a Succession Plan

In preparing for a camping trip, the Boy Scout has a variety of Swiss Army knives from which to select. Some are relatively simple with only two blades, while others contain a variety of tools. The type of knife that the Boy Scout should purchase depends on the problems or tasks that he expects to encounter on his trip.

Similar to Swiss Army knives, succession plans can be structured and modified to incorporate the necessary "tools" needed to meet the needs of the particular situation. Generally, however, the succession plan should consider two main issues: the transfer of authority and the transfer of ownership, if the successor is a family member.

Authority vs. Ownership

The distinction between authority and ownership is very important in the context of succession planning. Since many of today's closely-held business owners also serve as the company's president and/or CEO, they have rarely had occasion to differentiate between the two.

The title of president and/or CEO normally grants the successor the authority to make the day-to-day decisions of the company. Stock ownership, on the other hand, represents the legal right to vote on company matters, elect the board of directors and, through it, hire and fire company executives and set their compensation. Therefore, it is important to realize that naming a successor as president or CEO, gives that person only authority in name. The shareholders have the power to oust the successor and may do so specifically to undermine the business owner's succession plans after he is gone. An employment contract may be used to ensure that the successor maintains his authority. However, it should be carefully drafted so that the shareholders can make changes if the successor is not performing his duties as president. Likewise, as stated earlier, siblings should not automatically be employed by the company simply by virtue of their stock ownership.

Transfer of Authority

The transfer of authority to the successor should be planned in detail. A timeline should be established wherein definite dates are stated for certain events to occur. Although each situation is different, the timeline might state a definite date for the successor to be named President and for the current President to work part-time in a consulting capacity, or to fully retire. Again, although the dates can change, it is important for everyone to work toward a specific date, otherwise it can easily be put off indefinitely.

Transfer of Ownership

As important as the transfer of authority is the transfer of ownership. In contrast to the transfer of authority, there are many legal, tax and valuation issues which complicate matters. As a result, it is essential that outside advisors be consulted. These advisors often consist of corporate and estate planning attorneys, the business' accountant, business appraiser and financial planner or insurance agent. These professionals then work as a team to help create and implement the succession plan.

Outside advisors can also educate the family members on the transition. Regularly scheduled and structured meetings with the advisors and the family members can address the concerns of the family members and how those issues will be solved.

The transfer of ownership can either be through a sale, or by a gift and/or bequest, or a combination thereof. Tax issues will play a large part in the decision as to which method is best. A sale of the business will likely trigger capital gains taxes and will leave the entire proceeds in the owner's estate. Gifting of minority interests is a great way to transfer ownership and reduce estate taxes as well.

Selling the Business

As stated earlier, the business owner may conclude that selling the business is the best option. If the sale of the business is to a

related party, the sale must be on an arm's length basis to avoid a gift on a "bargain sale". An appraisal by an accredited business appraiser is recommended in the determination of the sale price.

Income taxes on the sale can be deferred by the use of an installment note and electing to use the installment method of reporting the gain. However, the seller then assumes the risk of default, and the value of the note is subject to estate taxes. Consideration should also be given to the potential use of a Charitable Remainder Trust in a sale, before an agreement is reached, in order to enhance the after tax proceeds to the seller.

Another potential avenue is a sale to an employee stock ownership plan (ESOP). Although beyond the scope of this article, it can provide a tax advantaged means of selling a business at an appraised market value, without taking the time necessary to find an outside buyer, and without the hassle of negotiating a price.

Bequest and/or Gift

Transferring a business by bequest and gift can be structured to be very advantageous with respect to estate and gift taxes. It is well established that minority interests in closely-held entities are worth much less than a pro-rata share of the entire business, and this fact can be used to the business owner's advantage. Gifts of a series of minority interests can be made with each gift being valued at substantially less than a pro rata share of the total value.

Minority interests in closely-held businesses are valued by applying minority and lack of marketability adjustments, which can together often exceed 50%. A minority adjustment takes into account the minority shareholder's lack of control of the business. Minority interests do not have any of the benefits of control which include: 1) The ability to change the company's articles of incorporation or by-laws; 2) The ability to elect directors and, through the directors, appoint officers of the company and set their compensation; 3) The ability to liquidate, dissolve, merge, acquire, or distribute assets of the company; 4) The ability to recapitalize the company; 5) The ability to declare and pay dividends; 6) The ability to control the policies and direction of the company.

The lack of marketability adjustment takes into account the fact that an interest in a closely-held entity lacks liquidity. Some of the factors that determine the lack of marketability adjustment are the historical and prospective financial condition of the subject entity, its distribution pay-out expectations, its level of risk, the control powers of the subject interest, and any restrictions upon transferability.

Published studies are often used as benchmarks in determining the lack of marketability adjustment for a minority interest. The early studies that tried to quantify the lack of marketability discount examined the sale of restricted stock versus sales of the same stock in the public market. More recent studies are based on the difference between the actual trading price of stocks before they went public versus the price of the initial public offering of the stocks. These more recent "IPO" studies indicate much larger lack of marketability discount than the earlier "restricted stock" studies.

Table 1 shows these discounts in U.S. Tax Court cases from 1988 to 1995. The range for the lack of marketability discount is 10% to 40%. The Court consistently found minority discounts of 20%. However, more recent data shows lack of marketability discounts of up to 80%, and higher minority discounts as well.

While there were several court cases which allowed minority adjustments in family controlled companies, the IRS did not recognize the validity of minority discounts in these situations until Revenue Ruling 93-12 was issued in 1993. The ruling reversed the IRS's previous position that no minority interest adjustments were available for transfers among family members. Consideration is given to each individual gift rather than viewing the entire family as one controlling interest.

However, in certain situations, the minority adjustment is offset by a "swing block" premium. This occurs when the subject block of stock could be combined with another minority block to achieve control of the company. One example of this (See TAM 9436005, May 26, 1994) involves a father who gifted 30% percent interests to each of his three children. If one child would like to obtain control of the company, he would be willing to pay a premium for the other 30% interest to obtain control. However, the "swing block" premium only applies to situations in which there is a willingness and an ability of one shareholder to purchase the subject block.

When owners want to retain control and end up owning a controlling interest at their death, the discounts described earlier are significantly lower. Obviously, there is no minority discount (as control is being transferred), and a premium for control is often applied. The lack of marketability discount is significantly lower because controlling interests are much more marketable.

With the federal estate tax as high as 55%, it is easy to see the

tax advantages of using gifts of minority interests. It is essential that an accredited business appraiser be used to value the interests gifted, as substantial penalties may be applied if there is no reasonable basis for establishing the value of gifted or bequeathed interests.

The advantages of a gifting program to transfer ownership to children are highlighted by the following example. Acme Company, if sold in its entirety, is worth $1 million. The Father (F), a widower, has two children; a son (S) and a daughter (D) to whom he wants to transfer the Company. The Company is expected to grow in value at a rate of 10% each year. Assume that F has a life expectancy of 10 years.

If nothing is done, in 10 years F will own a Company that is worth $2.6 million. Even if F qualifies for the small business exclusion of $1.3 million, the estate taxes on the Company's value would be substantial.

However, if F had made initial gifts of 25% of the Company to S & D each, followed up by additional gifts the next year of the same amount, he could escape gift and estate taxes altogether. Since minority interests in closely-held companies are worth much less than a pro-rata share of the value of the entire company, the gifts of 25% of the Company would be valued much less than $250,000 each. Assuming a total discount of 50% for lack of control and lack of marketability (which is within the range of normal discounts) the 25% interests would be valued at $125,000 each the first year, and $137,500 the next year (assuming 10% growth). Since $600,000 of the transfers can be made without paying gift taxes, the entire transfer is done tax-free. If the values or the growth rates in the above example are increased, the benefits of gifts become even more substantial.

In addition to the tax advantages, gifts of minority interests provide a great way to involve the next generation in the family business.

Maintaining Income

If the business owner has decided to name a successor rather than to sell the business. He will likely begin to transfer stock and take a less active role in the business. Probably, the issue foremost in the business owner's mind is how he or she will retain enough income to live on after the successor assumes control. This issue can be addressed through a consulting agreement, a retirement plan or by retaining control through voting stock as described below.

Keeping Control

If the business owner does not want to relinquish control of the business before his death, he or she may want to only gift an amount of stock that still leaves him or her with a controlling interest. The problem is that the interest will be valued as a controlling interest in his or her estate, reducing tax savings and possibly producing a liquidity problem, in that there might not be enough cash to pay estate taxes.

An alternative is to recapitalize the stock of the business into a few voting shares, which are retained by the business owner, and many shares of non-voting stock, which are gifted to children using the unified credit and annual exclusions. Although the stock retained by the business owner is valued as a controlling interest, it constitutes a much smaller portion of the entire equity, and thus has a lower value for estate tax purposes. Recapitalization is a non-taxable event and it will not affect an S corporation status.

Buy-Sell Agreements

No discussion about succession planning is complete without discussing buy-sell agreements. These agreements provide the means for an orderly transfer of ownership upon any number of triggering events, which typically include the death, disability, voluntary or involuntary departure of the business owner. There are different types of buy-sell agreements. If the corporation agrees to re-purchase the shares of stock, the agreement is a Corporate Purchase Agreement. If the remaining shareholders each commit to purchasing the ownership interest of the deceased or retiring owner, the agreement is a Cross-Purchase Agreement. A Hybrid Agreement is simply a combination of the Corporate Purchase Agreement and the Cross-Purchase Agreement.

Buy-sell agreements can be very advantageous to both the buyer and the seller. One of the advantages to the seller is that they provide for a purchaser of the stock, thereby generating some liquidity. Other seller's advantages of buy-sell agreements are that they may freeze the value of the closely-held shares for estate tax purposes and provide a method for withdrawing funds from a family corporation other than through dividends.

One advantage to the buyer and the remaining shareholders is that it could remove the friction between the surviving shareholders and the deceased shareholder's heirs. The agreement also can prevent hostile third parties from purchasing shares. Another advantage of buy-sell agreements is that an S

Corporation election can be preserved by ensuring that the purchaser is a qualified S Corporation shareholder. The agreement can also provide that life insurance be purchased so that the buyer has sufficient funds to purchase the shares.

Crucial to the buy-sell agreement is the provision for valuation of the business. It is recommended that this provision be developed by an accredited business appraiser in order to meet one of the tests necessary for the buy-sell agreement to be binding for estate tax purposes. If the agreement is not binding for estate tax purposes, it is possible that the actual amount received under the agreement would be much lower than the value for estate tax purposes, possibly producing a liquidity problem with respect to estate taxes.

In order for the buy-sell agreement (ones created after October 8, 1990) to be binding for estate tax purposes, Section 2703 of the Internal Revenues Code provides three requirements: 1) the agreement must be a bona fide business arrangement; 2) the agreement must not be a device to pass property to family members at less than fair market value; and 3) the terms must be comparable to similar arrangements entered into by persons in an arm's length transaction. These tests must be independently satisfied. If persons who are not members of the transferor's family own more than 50% of the business, the tests are deemed to be satisfied. Other requirements are that the agreement must restrict the owner's interest during lifetime, require the owner's estate to sell, and that the purchase price be determinable from the agreement.

Buy-sell agreements should be drafted very carefully. Unanticipated negative consequences can occur if they are not. For instance, I came upon a buy-sell agreement which stated that the formula to calculate the purchase price would be based upon the last year's financial statements. It did not, however, state whether the statements had to be in accordance with generally accepted accounting principles. Meanwhile, the company had purchased another company and held it as a subsidiary. This subsidiary was represented in the company's financial statements at cost. The triggering event then occurred, and the company's value under the literal language of the agreement was much lower than its fair market value. The parties were forced to negotiate a settlement, expending needless time, energy and money. Obviously, the seller was not happy with the result.

Another negative consequence can occur when the language used still leaves the intended meaning on how to calculate the value unclear. For example, I have often seen buy-sell agreements with the language "the stock shall be valued without any premiums or discounts". This language gives the business appraiser no guidance, as all businesses are appraised using discounts and premiums. A controlling interest inherently has a control premium and a minority interest inherently has a minority discount. A good way to avoid this would be to have a business appraiser look at the agreement and decide whether or not the wording is ambiguous from a valuation perspective. This would help ensure that everyone understands how the value will be calculated upon the triggering event.

Treating Children Equally

Most business owners have a desire to treat their children equally and have a tendency to want to transfer equal portions of their business to their children. However, experts have long advocated that only children working in the business should have ownership interests. The reasons for this include the fact that children that hold an ownership interest but do not work in the business feel that they should be getting income from the business, while those working in the business resent doing the work and giving a portion of it to their non-working siblings. This type of conflict can be avoided by giving the children who aren't working in the business other assets. These other assets could be the real estate used by the company (with a fair market long-term lease), marketable securities or life insurance proceeds.

Another option is to allocate voting stock to the child, or children, that is/are active in the business. The children that are not active in the business would get the non-voting stock in the company. This method helps to ensure that all of the children are treated more fairly. This option is especially useful when the company represents most of the owner's estate, but it does not prevent bickering among siblings.

In some cases, there are several children in the business who disagree as to the direction of the company. If there is no clear front runner as to who is best able to run the business, separate companies can be set up and given to each of them. Section 355 of the Internal Revenue Code allows a corporation to be divided into two separate corporations, tax-free, which may be owned by siblings. This is accomplished by creating a wholly-owned subsidiary and then splitting off the subsidiary in exchange for stock of the original corporation.

Implement the Plan

A Swiss Army knife is of little consequence if it is left in the Boy Scout's back pack and never used. Likewise, a succession plan accomplishes little if it is stashed in the owner's filing cabinet and never implemented. Implementing the plan can be the hardest part, as the business owner must begin to take a less active role. The owner often started the business, and probably had spent more time with it than his family. A business is often the owner's "baby" and can be difficult to relinquish. However, since the process to create the plan should have included significant input from the other family members and a significant amount of time and energy, there is usually enough momentum to go forward and implement the plan.

The successor should be announced, as well as a timeline for the transition. The process of grooming the successor should begin, and transfer of ownership should begin as well. A buy-sell agreement should be signed, life insurance, if needed, should be secured, and estate planning techniques should be executed.

Grooming the successor is a very important stage of the implementation process. Financial concerns are only part of the business that the new leader must learn. Other issues such as getting to know the customers and making them feel comfortable with the transition are very important to the survival of the business. Maintaining the goodwill, trust, and respect of the company are also very important to the continuation of the business.

Summary

Succession is not something that just happens. A business owner should utilize a team of advisors, including his or her family, in order to devise and implement a succession plan that takes into consideration the human issues, the financial health of the business and tax issues. After the succession plan is implemented, the business owner should feel confident that all has been done to help ensure the long-term viability of the business and achieve the goals of the family.

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Table 1

Discounts in U.S. Tax Court Cases

Case	Lack of Marketability	Minority	Combined Adjustments
Estate of Clara S. Roeder Winkler (1989)	25%	20%	
Estates of Neff and Clow (1989)	10%		
Estate of Gladys H. Titus (1989)			25%
Estate of Newhouse v. Comm'r (1990)			35%
Estate of Albert L. Dougherty (1990)	25%		
Estate of Edgar A. Berg (1991)	10%	20%	
Estate of Catherine Campbell (1991)			35%
Estate of Charles Russell Bennett (1993)	15%		
Estate of James H. Gray, Sr. (1993)			5%
Estate of Ray A. Ford (1993)	10%	20%	
Estate of Jung V. Comm'r (1993)	35%		
Estate of Star C. Simpson (1994)	10%		
Estate of Joseph H. Lauder (1994)	40%		
Estate of William F. Luton (1994)	20%	20%	
Estate of Anthony J. Frank, Sr. (1995)	30%	20%	
Bernard Mandelbaum, et al. (1995)	30%		