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THE FARRELL LAW GROUP
IS READY TO ASSIST YOU IN CREATING AND IMPLEMENTING YOUR BUSINESS SUCCESSION PLAN

History has shown us that less than 30% of family owned businesses survive the transition from the first to the second generation, and only one in ten survive to the third generation. Why? There are fairly straight-forward financial and estate planning tools that can be used to create an effective succession plan. However, it is almost always a lack of attention to the "non-technical" issues, the "people issues", that destroys a "technically sound" succession plan. It is therefore critical to **not** focus only on the technical tax and estate planning issues in creating a succession plan. Rather, it is the underlying emotional and psychological issues, especially at the beginning of the creation of a succession plan, that are the critical part of the overall information gathering and planning process. If the business owner and his/her advisors fail in this critical first step, the entire process may very will be doomed from the outset. Only after the "people" foundation is properly prepared can the technical options be reviewed, and choices made. In the final analysis, it is the attitude of the business owner(s) that will determine whether or not the plan for the future will succeed, or fail.

Q. What is Business Succession Planning?

A. The need for a business succession plan first arises out of a decision to pass an existing business onto future generations, rather than to simply sell the business. Once a decision is made to keep the business, and pass it on to future generations, decisions must be made about: Who will run the business; how will they run it; who will own the business; how will they own it; how will the retirement of the present owners be funded; how will the estate taxes that will come due in the future be paid; how will the liquidity of the business be preserved while funding the retirement of the present owners, and paying estate taxes?

Q. What are the first issues that need to be dealt with when creating an effective succession plan?

A. Contrary to popular belief, it is the "soft" issues that first have to be identified **in depth**, and resolved, rather than the creation of a technical plan to implement the intended succession of ownership and control of the business.

Q. What are the "soft" personal and psychological issues that have to be addressed?

A. Although each situation is, at least to some degree, different, in almost all family business succession situations the following issues must be confronted completely, and objectively, from the start: can the present owner surrender control; does the present owner understand that he/she will die or become unable to run the business; will the owner's marriage survive giving up the business; do you trust those to whom you would give the business; are there rivalries among your children or others that must be resolved as part of the business succession plan; are there unresolved conflicts, grief or jealousies between family members or others that have to be dealt with; are there past mistakes that have been made that must be dealt with; is there a generational "value conflict" that needs to be addressed; how does the business owner "equalize" what he/she wishes to leave to the children, or others, as part of the succession plan; can the owner admit to his/her fears about leaving the business to other family members, and how are those fears dealt with; have there been problems in the past with communication among family members? Put these in the form of a list, spend the necessary time to <u>think</u> about the answers, and <u>write them</u> out

Q. How can all of these "soft" issues be properly addressed?

A. All of these issues have to be addressed <u>first</u>, before any technical issues implementing the succession plan are reviewed, or decided on. The entire planning process will break down if there is an attempt to "rush to completion". The failure to address the family issues <u>before</u> tax planning issues, or ignoring some family members, ignoring key non-family employees, failing to address ownership succession issues, failing to address management succession issues, failing to create an objective process, and fully include family members to cultivate trust, communicate honestly, and participate in key decisions, will result in a failure of the plan. In other words, don't even bother moving to the technical plan implementation issues, unless, and until, you have invested time and effort in dealing with all of the "soft" issues that will be, in the end, at the core of the succession plan.

Q. How can the process of creating a business succession plan be started? The initial planning team and the preliminary meeting.

A. After deciding that you want to pass the business to family members rather than sell it, <u>the first step is to assemble your planning team</u>. This team will consist of you (the business owner), the spouse of the business owner, your lawyer, accountant, and, if available, a trusted business advisor. You should also consider including key employees. The next step is to hold <u>scheduled preliminary meetings with the initial planning</u> team in order to explore all of the previously listed "soft" issues <u>completely</u>. At the initial meetings all of the "soft" issues must be explored candidly, and the opinions of everyone involved sought out actively. These <u>preliminary meetings</u> should result in the development of a <u>complete outline of the most important issues to be addressed among the members of the family</u>, as well as key employees, in order to promote a full discussion of all of the most important issues, and to also develop insights and preliminary thoughts (not a plan) to begin to discuss the business succession plan with family members, and to <u>seek their input</u>. Always keep in mind that the major questions will ultimately be: who will <u>run</u> the business; <u>how</u> will they run the business; who will <u>own</u> the business; <u>how</u> will they own the business; how will the <u>retirement</u> of the departing owner(s) be funded; how will the <u>estate taxes</u> be paid; how will the <u>liquidity</u> of the company be protected?

Q. What is the next step after fully exploring all of the preliminary issues with the initial planning team?

A. As part of the preliminary meetings, you should have identified all of the individuals in <u>any way</u> relevant to the development of the succession plan, including all "soft" and "hard/technical" issues. Now you must <u>expand the group</u> beyond the initial planning team. Contact all of those people to inform them of the intention to include them in the development of the complete succession plan for the business.

Then develop a <u>formal plan for conducting meetings</u> between everyone involved to obtain their complete and candid input. That plan must include; the <u>location</u> of future meetings (remember to respect everyone's schedule); <u>coordination</u> of the meetings (place one or more people specifically in charge of this coordination process); the selection of <u>facilities</u>; the setting of <u>specific times</u> for meetings; the development of an <u>initial agenda</u> for the first meeting. All of these things must be developed <u>in advance</u>, and not in a haphazard manner, in order to insure that you create an environment that will not only provide an opportunity for open, complete and candid discussion, but to absolutely <u>insure it</u>.

Q. Is it important to have an agenda for these meetings?

A. Having an agenda for each meeting is <u>critical</u>. An agenda provides a "road map" for active discussions to take place. Everyone should receive the agenda at least several days in advance of each meeting date. After the first meeting, everyone in attendance should participate in the formation of the agenda for the next meeting, highlighting the problem areas identified in the completed meeting. A series of dates should be established for all future meetings in advance. Communication should also be facilitated between meetings in order to insure full respect for the input of all, e.g. the exchange of emails between meetings; the development of a web site to facilitate discussion and information transmission, etc.

Remember, do not consider moving to the hard and technical issues regarding implementation of the plan until everyones' input has been completely obtained. Let the process run its course. The process <u>will work if you let it work</u>. Do not rush to completion. If the "soft" issues are addressed completely and in good faith, <u>you will know</u> when to move on to the "hard/technical" issues.

Q. Since the agenda for each meeting is so important, can you suggest some type of outline to follow?

A. First, <u>at the top</u> of each agenda state <u>the goal</u>, i.e. the creation of an effective succession plan for the transfer of the control, and ownership, of ___________ company.

Then: should the business be sold or passed on to future generations (this is an issue that everyone should discuss at the first meeting). If the decision is to keep the business in the family: who is <u>most capable of running</u> the business effectively in the future; <u>how will they run</u> the business; who would it be <u>best to have own</u> the business; <u>how will they own</u> the business; how will the interests of those who will run the business, and those who own the business, be <u>balanced</u> against those of other family members who will not be involved in either owning, or running, the business; what will the <u>retirement needs</u> of the departing owner(s) be; how can those needs be <u>met</u>; will the <u>departing owner(s) stay involved</u> in the ownership or operation of the business in any way; how will the <u>liquidity of the business</u> be protected while paying for the retirement of the departing owner(s), and paying for estate taxes.

This does not represent an exhaustive agenda for the first meeting of the expanded group of people involved in developing this succession plan. However, it provides an outline of the most significant issues.

Q. After fully addressing all of the "soft" issues, what are the "technical" issues that first have to be addressed?

A. The first "technical" issue is <u>valuing the business</u>, i.e. how much is the business worth, and how much is it reasonably expected to be worth <u>in the future</u>, after the implementation of the succession plan? One or more competent appraisers should be identified, and retained, in order to complete the first step of valuing the business.

Q. What "tools" are available to implement the succession plan decided upon?

A. An in-depth discussion of the various techniques and alternatives to implement an appropriate succession plan goes beyond the purpose of this brochure. However, there are several effective tools that can be implemented, often in combination, to maximize the opportunity to successfully implement the succession plan. Those include: 1. <u>Use of the credit against federal estate and gift taxes</u>: each individual has a federal "credit" that can be used during their lifetime against gift taxes, or applied against estate taxes, thereby reducing, or eliminating altogether, gift taxes, or estate taxes that are due at death. For 2003, this "credit" allows an estate valued at one million dollars to pass free of federal estate taxes. In 2004-2005, this amount is increased to $1.5 million. In 2006-2008, the "credit" allows an estate of up to two million to pass free of federal estate taxes, and in 2009 the "credit" allows an estate of up to 3.5 million dollars to pass free of federal estate taxes. The combined credits of a husband and wife (each of whom has their own "credit" available to them)can be used to reduce or eliminate estate taxes, and allow a business valued at twice the amount of an individual's credit to pass to future generations without incurring federal estate taxes if properly used.
2. <u>Lifetime gifting</u>: Each person may presently gift up to $11,000.00 per year to each person receiving a gift. A husband and wife can combine to give $22,000.00 to a person without incurring any gift tax. There is no gift tax on gifts between spouses. By combining these credits amongst a number of individuals receiving gifts, over a number of years substantial value can be transferred by gifting shares of stock or other ownership interests. Another tool using lifetime gift-giving is to gift major portions of a business, in excess of the $11,000.00 annual gift tax exemption amount, and use the lifetime "credit" to avoid the necessity of paying gift taxes. This can be especially effective where the value of the business is expected to increase substantially in the future. This technique results in gifting the value of the business presently, with the anticipated future appreciation of the business occurring after it has passed to the new owners. However, always be sure that transfers of stock, or other ownership interests, are subject to subsequent transfer and control restrictions to insure they stay in the family.

3. <u>The use of instalment sales:</u> by making a gift of stock, or of another ownership interest in the business, a gift-giver receives no income benefit. However, by selling stock at a determined value, and receiving back a note requiring regular payments, with interest, the seller (i.e. the owner) will receive a regular cash flow. The benefits realized from an instalment sale are enhanced by selling several *minority interests*, e.g. selling interests to several different children. This is because minority (i.e. non controlling) interests in a business have a substantially discounted value attributed to them. An instalment sale removes stock from the seller's estate, thereby avoiding estate taxes on the appreciation of the stock after the sale is made. Only the remaining value of the note is included in the estate of the seller. If structured correctly, it is also possible to eliminate the inclusion of even the remaining amount of the instalment note in the estate by using a "death terminating instalment note", for which the purchaser must pay a "premium". An additional benefit is that the seller can

spread the income received from the sale over a number of years of the instalment note in order to avoid being taxed in higher tax brackets.

4. Annuities (GRATS, GRUTS, and private annuities): Most simply, annuities consist of the transfer of assets by a seller in return for payments to be made for an agreed period of time, or for the remainder of the life of the seller. The creation of these types of annuities requires compliance with rules that can sometimes be complicated.

In the case of a "grantor retained annuity trust" (GRAT) the owner of the assets (e.g. stock in the family company) transfers the assets to a trust, but keeps control over the trust until the payment obligation has been satisfied. The payments required to be made to the owner are established by an agreement between the owner of the asset (seller) and the trust.

In a grantor retained unitrust (GRUT) the payments to be made by the seller are variable, and are based upon the profits generated by the value of the assets placed into the trust. In either case, after the completion of the payments for the agreed period of time, the ownership of the assets placed into the trust goes to the named family members.

The result, if the payment period is successfully completed, is to remove the assets from the estate of the owner (thereby avoiding estate taxes), generate income to the owner after the transfer of the assets to the trust, and ultimately transfer the ownership to the desired family members. However, there can be problems if: the owner doesn't survive long enough for the payment period to be completed, in which case the asset can be included in the estate at the death of the owner; gift tax obligations occur when the assets are transferred to the trust; the assets transferred need to produce regular income in order to meet the annuity payment obligations.

Another tool is the "private annuity," where the owner sells the assets to family members in return for an unsecured promise to pay amounts for the lifetime of the seller. The amount of the regular payments to be made to the seller are determined by using prescribed life expectancy/annuity tables. At the death of the seller the annuity payment obligation ends. There's also no gift tax problem because the calculation of the lifetime annuity payments is intended to cover the entire value of the assets being transferred, i.e. there is no "gift." The major "problem" with private annuities is if the seller lives longer than the calculated life expectancy, which results in the buyers paying more than the initially calculated value of the asset. However, this "problem" can often be overcome by the expected increase in value of the asset after the transfer is completed. Private annuities can be extremely useful in the case of an elderly seller whose life expectancy is expected to be shorter than that calculated under the life expectancy/annuity tables.

5. Considering diverting future opportunities for the business: a final "tool" is for the owners of a business to decline a significant business opportunity that may be presented to the existing business, and "transfer" that opportunity to younger generations to establish a new venture. Since the "future opportunity" likely has little present value, there is no present "transfer" subject to substantial tax, and the development of future value from the new venture will go to other family members.

Conclusion

By addressing the "soft" issues first, systematically, completely and candidly, the chances of creating a successful business succession plan are greatly increased. Only after dealing completely with the "soft" issues should work on the "hard" and "technical" issues dealing with the "tools" that will be used to actually implement the plan that has been decided upon be started. There are many technical "tools" that have proven to be successful, alone, and used in combination with one another, that your "technical"professional advisors can help you to decide on and implement. But (and I know it is repetitive) without confronting the family "soft" issues first, the selection of the technical "tools" often makes little difference. Regardless of the creativeness of the technical people, the great majority of succession plans are doomed to failure without resolving all of the "soft" issues first.

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We hope this information helps you. It is important to understand that you need the assistance of professionals who are knowledgeable in the field of business succession planning in order to make the decisions that are necessary to create a succession plan that is appropriate to your needs, and to your desires, and to implement the plan agreed upon by the use of the proper documents. If we can be of further assistance to you, please contact us by phone or e-mail at your convenience to schedule a conference.

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