BUSINESS SUCCESSION PLANNING

ADVICE FOR THE PLANNER

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How to Get Started? Begin at the End!

Talking about business succession planning is one of the most challenging topics a planner can broach with a client. Why is it so hard to tackle this issue? Business succession planning deals with not just the specters of death and taxes, which are challenging enough, but also forces the client to contemplate the bigger concepts of legacy, retirement, fear of losing control, and impact on all of the stakeholders – family, key employees, customers, and others impacted by the business.

Every business is unique, so there is no simple set of instructions that applies to all cases, but there are basic issues that need to be identified and understood at the outset of succession planning.

1. **Understand the origin of the business.** Who started the business? What acquisitions have occurred since inception? Identify the ownership structure of the entity or entities at stake.
    - Entity type: C Corp, S Corp, LLC?
    - Multiple entities?
    - Whole or partial ownership? This is very significant with regard to options.
    - With multiple owners, identify all governing shareholder agreements, operating agreements, etc. that will control how shares or membership interests can (or cannot) be transferred.
2. **Understand the assets and nature of the business.** What can actually be sold or transferred? How will a change in ownership impact the value or functionality or goodwill of the business?
    - Assets of operating business: goods vs. services, inventory, accounts receivables, contracts, blue sky/goodwill, real estate, etc. Understand the cost basis, as this will impact tax consequences, and you will ultimately need to grapple with the valuation of the business.
    - In many cases, ownership of the operating business and ownership of real estate is separate, and this can be leveraged in numerous ways (sale vs. lease, active vs. passive involvement in the business).
    - A business based on professional services faces its own unique challenges; e.g., you can't sell or pass on a law practice to someone not licensed to practice law.
    - Women or minority owned business designations can be lost in the succession; how will this impact the value of the business?
3. **Now, begin at the end:** ask the client to envision what they see as the end result of their business succession planning. What does that look like? You cannot chart a path forward until you know where you are going!
    - Are there children that want to inherit this business? Are they working in the business? Be brutally honest when examining the aptitude and/or interest of children and other family members with regard to business succession. Is transferring ownership of the business to family members, whether during the owner's life or at death, in the best interest of the business? What about the other stakeholders?
    - Are there key employees that are interested in ownership? How would their acquisition be financed? Does the cash flow of the business suggest an opportunity to finance key employee equity acquisition through a bonus structure?

- Is an ESOP (Employee Stock Ownership Plan – an employee benefit plan that can be used to facilitate succession planning) an option?
- Is the best option for all or most stakeholders really just to sell to an outside party for the highest possible price? What does this look like? Working with an industry specific business broker might be the best route to maximize value for sale.

4. **Ask the tough questions, and think about Timing: Proactive vs. Reactive**

   - Is your client really ready to give up any control? Sail off into the sunset vs. hand from the grave – understand the psychology or you will never get a plan executed.
   - Ask your client if they want to control the succession, or have the business and family dealing with chaos in the event of unexpected disability or death. Chaos is rarely the preferred result.
   - Focus on identifying potential successors, whether that means co-owners, family members, key employees, an ESOP, a competitor, a private equity firm, etc.
   - Starting sooner than later makes everything easier, whether that is procuring affordable key person life insurance, polishing the assets to maximize sale value, or implementing a lifetime gifting strategy. The longer your client waits, the fewer options they have.
   - Gifting vs. selling: is your client really ready and able to get assets out of their estate now, or is there a concern with future income security?

5. **How does the business succession planning tie in with the estate plan?**

   - Is there a taxable estate? What about the upcoming sunset of the unified credit amount in 2026, which will cut the credit in half? This may be a reason to contemplate lifetime gifting now to use up the larger amount, which the IRS has said they will not claw back. Is the client maximizing annual gifting?
   - With larger and more complex estates, can the entity be gifted in pieces (e.g. voting and non-voting interests) that would qualify for a minority discount? If there are multiple operating entities or assets, focus on discounting and gifting those with the highest future appreciation potential vs. more mature, less growth oriented assets. Can the entity's debt be allocated or reorganized strategically?
   - If there are charitable gifting goals, how can low basis assets be utilized strategically? Particularly in a higher rate environment, a charitable remainder trust can be a powerful tool to maximize gifting while retaining lifetime income.
   - If the business succession is part of the estate plan, and there are multiple heirs, is the plan equitable? Are children working in the business favored over those who are not? How will this impact family relationships in the future?

6. **Timing of valuation – don't rush in!** While it seems like the first thing we need to know is the value of the business at the heart of the planning, be careful! You don't want to seek a professional valuation until you know the final goal of the succession plan. Are you really wanting the biggest, flashiest valuation possible? Absolutely yes, if you are polishing this asset for sale. But what do you do with that (potentially discoverable) grandiose valuation when the client decides they want to embark on a gifting strategy and now you need to be prepared to defend something closer to book value with a 30% discount? Don't get a formal valuation until you know whether or not you are valuing it for a third party buyer or the tax man!

7. **How do tax consequences impact decision making with regard to the plan?**

- Assets gifted during life have a carryover basis, so be aware of the tax consequences associated with that gift, whereas assets transferred at death may get a step up in basis.
- Understand that key employees and family members working in the business can receive benefits or payouts from succession in multiple ways. Employment or Consulting Agreements are an important tool and negotiating point in any Buy-Sell, but understand the very different tax consequences associated with compensation income (ordinary income w/ associated employment tax) vs. LTCG treatment of sale proceeds (currently capped at 20%)
- Tax consequences should always be considered, but they cannot drive the plan. Getting the client to come to terms with their true dispositive intent must come first, and take precedence over tax consequences. This is particularly important, because your client will not be happy if they do something that they don't really want to do, and a future change in the tax law makes the whole thing moot. Unfortunately, the tax code comes with neither future promises nor a crystal ball!

Your client will ultimately want to assemble a team of Trusted Advisors to help guide, develop, and administer this plan. Hopefully they have most of this team in place – CPA, corporate attorney, estate planning attorney, banker, and financial adviser – and will be ready to bring in others as needed, at the appropriate time. This may include a valuation expert and an industry specific business broker. Helping the client figure out what they really want to do before they get everyone in the room is the greatest thing you can do for them and their family. This means talking about options, and encouraging your client to have those tough and honest conversations with their family, key employees, and other stakeholders. Sometimes they think they know what others want, and it isn't the case at all, so encourage everyone to really get honest, with themselves and others, about their thoughts, feelings, fears, dreams, and goals. Good luck!

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Christine has 29 years of experience in trust administration, estate planning, and corporate law. She has worked in the corporate fiduciary environment as well as in private practice. Christine is working with our clients to provide trust, estate, and private wealth management services, with a strategic focus on holistically serving the needs of business owners and their families.

Christine grew up in the Kansas City area, and earned her undergraduate and law degrees from the University of Kansas. She resides in Leawood, Kansas, with two gray tabby cats, and has two grown sons that have recently left the nest. She's an avid reader, a supporter of the arts, and serves on the Board of Job One, a nonprofit that supports adults with disabilities. Christine enjoys traveling, particularly to visit her identical twin sister in the Netherlands.