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SUCCESSION PLANNING FOR SUCCESSFUL FAMILY BUSINESSES

Economic, tax strategies help with transition to next generation

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Business succession planning is a two-pronged process. Our first objective is to ensure the survival of the business, at least through the next generation. We must determine how to blend family and business priorities; who will run the business and who will perform the various tasks to assure its success.

Then we shift to the tax and business strategies to be adopted to get the business to survive and even thrive into the next generation.

The continued vitality of these businesses has a profound impact on the U.S. economy. Ninety percent of all businesses in the U.S. are family controlled. They produce over 50 percent of the nation's gross national product. However, only one-third of these businesses survive the second generation and only 15 percent the third generation.

One size does not fit all in the succession planning process. Our job as professional advisors is to make sure we understand the objectives of the founder and the family and to be both flexible and knowledgeable enough to be able to assist them in a tax-efficient manner, while providing firm guidance if it becomes apparent that they are heading down the wrong path.

Ultimately, the founder must determine how much control he should retain and for how long, and to whom it will be transferred.

The founder of the business must decide when and how to transfer the interest to the next generation. The children should all be treated fairly, but not necessarily equally. The founder's objective should be to reduce or eliminate the interests of those siblings not in the business, and/or not capable of managing or even participating in the business. Ultimately, the founder must determine how much control he should retain and for how long, and to whom it will be transferred and, having made those decisions, how to continue to enjoy Thanksgiving dinner with all the siblings in attendance.

Assuming that we have dealt with the intra-family issues and have the right framework and frame of mind amongst family members, the focus of this article is on dealing with the subsequent economic and tax issues.

Providing For Liquidity

If the founder is in need of cash, then the creation of liquidity should take place during the founder's life rather than upon his or her death. The sale of the business during the founder's lifetime is simple and creates the opportunity for the entire family to cash out.

A recapitalization resulting in the sale of a significant interest in the business gives the family members the opportunity to take some money off the table.


Morris W. Banks

If the founder does not need liquidity during his life, then another way of creating liquidity is to provide for life insurance payable to the non-active children which will compensate them for their not having an interest in the business.

A further method for providing assets to children is to isolate the business real estate from the business. This provides an excellent opportunity by way of rental payments by the business to get cash on an annual basis to the founder (to provide retirement income) or to the inactive children as a method to compensate them for the transfer of the business to the active siblings. This is really a structure which should be used from the inception of the business. Real estate owned by a corporation is difficult, if not impossible, to spin off on a tax deferred basis under Section 355 of the Internal Revenue Service Code

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because the five-year active business requirement cannot be satisfied with real estate.

Under the right circumstances, the corporate redemption of the stock held by the founder is an excellent method to increase the percentage interests of the active siblings while at the same time getting cash out of the corporation to provide liquidity both to the founder and to the founder's spouse as well as to inactive siblings. The payments made in redemption of stock are not deductible by the corporation, but if you can satisfy the Redemption Rules of Section 302(b), as impacted by the attribution rules of Section 318, the cash received by the various family members will be subject to capital gains treatment. Installment sale treatment is also available if installment notes are issued by the redeeming corporation, thereby conserving corporate cash, while permitting the selling shareholders to defer recognition of gain while receiving interest income on the principal of the notes unreduced by the tax thereon.

Redemption of membership interests in a limited liability company setting will be equally salutary, but can be accomplished without the necessity of satisfying the restrictive IRC Section 302 rules applicable to corporate redemptions. However, the so called "hot asset" rules of IRC Section 751 must be considered in the case of the redemption of LLC or partnership interests.

Stock To Children

The sale of stock to the children rather than lifetime gifts may seem counter-intuitive because it imposes obligations on the children to make the payments to the founder and the founder ends up with the value of those payments in his or her estate. However, several goals are accomplished:

- The stock is transferred to the children who are active in the business while making cash ultimately available to non-active siblings.
- The active children now have a financial stake in the success of the business.
- It freezes the value of the business as of the date of the sale, thus potentially resulting in a substantially lesser transfer tax to the founder, while increases in value of the interests attributable to the activities of the active siblings inure to their benefit. Installments sales to the children will permit Mom or Dad to defer payment of the capital gains tax on the sale until the cash is received. If the founder dies before the note is paid, the value of the note will be included in his estate. While he is living, the payments provide another source of retirement income.
- The use of self-canceling installment notes (SCINs) should be considered under these circumstances. A SCIN is an installment note that is cancelled automatically on the death of the seller. If the seller dies before the end of the term, the unrecognized gain on the sale is accelerated, but the unpaid portion of the note is *not* included in the estate of the seller. Also, no cancellation of indebtedness income is recognized by the buyer who issued the note upon its cancellation.

Inter Vivos Gifts

An alternative to selling stock is the outright gifting of the company's stock during the life of the founder. This starts moving more into the realm of estate planning, although the motivations are certainly succession planning. The results of such gifts should be analyzed from the standpoint of the overall estate plan of the founder or transferor. Gifts of business interests can assume a number of different forms:

- Outright transfer to family members. This is fairly straightforward and such gifts may be subject to the illiquidity discounts and minority interest discounts.
- Net gifts of business interest are considered part sale and part gift. In this arrangement, the recipient agrees to pay the donor's gift taxes that become due by reason of the gift. The appraised value of the donor's stock, reduced by illiquidity and minority interest discounts, would be further reduced by the amount of the gift tax payable by the recipient. The payment of the gift tax results in the transfer by the donor being treated partially as a gift and partially as a sale. The entire tax basis of the stock being transferred may be allocated to the sale portion of the transfer and the sales price is the amount of tax being paid by the recipient. The gain to the donor, therefore, is the difference between the amount of the tax being paid by the recipient and the entire basis of the stock subject to the transfer. It would no doubt be a long-term capital gain to the transferor. The question then arises as to who pays the capital gains tax of the donor. If the recipient pays the capital gains tax, this will be treated as a gift by the recipient to the donor. To the extent that any of the parties are married, they can use the split gift provision in order to potentially reduce the amount of the gift tax owing in both directions.
- The use of family limited liability companies and family limited partnerships as vehicles to effect transfers of business interests to family members has recently come under attack by the Treasury Department. To the extent that you survive scrutiny, the gifts of limited partnership interests or limited liability company membership interests can support minority and illiquidity discounts with respect to each transfer of such LLC or limited partnership interest and a successor manager or shift in control of the general partner upon the death of the founder transferor can also be provided for in the instrument

Buy-Sell Agreement

In a sense, the last chance for any succession planning is upon the death of the founder. Although the founder may have the appropriate asset mix so that he can make bequests of his business interest to the children who are active in the business while adequately providing for his spouse and non-active siblings with other assets, such might not be the case. Under those circumstances, the transfer taking effect at death could be structured as a buy-sell agreement, most likely a redemption agreement whereby the corporation would purchase the stock from the estate of decedent for either cash or installment obligations.

A properly drafted buy-sell agreement will establish a date of death value and provide the appropriate liquidity to the estate of the deceased founder in order to both pay taxes, if there be any, and to provide cash to make the appropriate bequests to other surviving family members, that is the spouse and other children. Of course, after the redemption of the founder's business interest, those interests previously acquired by the active siblings either by gift or purchase will remain in place, effectively resulting in the transfer of total ownership of the business to such children.

Absent life insurance, if the entity does not have sufficient liquidity to pay cash for the decedent's stock, the entity can issue its installment obligations to the decedent. This raises a whole set of other problems including those arising from banking relationships whereby the issuance of such installment obligations may be prohibited under the financing documents. Indeed, the purchase of the interests for cash might very well also be prohibited under the standard negative covenants in the bank documents. Under any circumstances, such notes should provide for subordination to any bank or other institutional indebtedness.

Deferred Tax Payment

Section 6166 of the IRS Code provides important relief to a large number of estates where the stock of the business held by the estate constitutes more than 35 percent of the value of all the assets held by the decedent at the time of his death. If that requirement is satisfied, then the decedent's estate may pay the taxes over a 15-year period. In addition, the payment of the taxes can be deferred during the first five years whereby the estate pays interest only to the U.S. Treasury at a fairly low rate and only thereafter from the fifth to the 15th year are the taxes paid in 10 equal installments, together with interest on the unpaid balance.

In the event that a redemption agreement exists between the decedent and the company or a cross purchase agreement between the decedent and his surviving siblings which provides for payments in installments, the installments must be paid in such a manner so as to assure that the payments under Section 6166 are not accelerated. By careful draftsmanship, the installment payments can be coordinated with the amounts otherwise payable under the deferral provisions of 6166, thus avoiding any acceleration, but at the same time providing a portion or all of the liquidity with which to pay such taxes.

In succession planning, we're not always so lucky that all the components and all the constituencies come together as we would like. However, careful advance planning can maximize the possible successful transition of the family business to succeeding generations. ■