

## Business Succession Planning

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## Agenda

- Overview of business succession planning
- Business succession planning techniques



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## Overview of business succession planning

- More than 80% of businesses in the U.S. are private and/or family dominated
- Businesses owned or dominated by the members of a single family make up 175 of the Fortune 500
- International Family Business Program Association estimated that family firms contribute 60%-75% of the U.S. G.D.P.

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Overview of business succession planning

- **Closely held businesses have an extraordinary failure rate:**
  - 70% do not survive to the second generation
  - 85% do not survive to the third generation
  - The average family owned business lasts only 24 years

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Overview of business succession planning

- **Why do so many businesses fail after the first generation?**
  - Failure to develop a comprehensive strategic vision
    - Ownership
    - Control
    - Management
  - Failure to address basic issues of ownership succession planning and estate planning

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Wealth transfer techniques

- **Four techniques for business succession planning**
  - Buy/Sell Agreements
  - Family Limited Partnerships
  - S Corp Recapitalizations
  - Intentionally Defective Grantor Trusts

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### Wealth transfer techniques

• **Technique #1: Buy/Sell Agreements**

- What is it?

An agreement used when two or more parties own a business together, to protect themselves, their heirs and the remaining owners, in the event of:

- Death
- Disability
- Divorce
- Irreconcilable differences




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### Wealth transfer techniques

• **Technique #1: Buy/Sell Agreements**

Why a Buy/Sell Agreement is Crucial

- Death of an Owner

- Heirs may need \$\$ to pay estate taxes or to live on
- Goals of remaining owners and heirs usually conflict
- Heirs may not be able to sell fractional interest to outsiders – forced to litigate or sell at a depressed price




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### Wealth transfer techniques

• **Technique #1: Buy/Sell Agreements**

Why a Buy/Sell Agreement is Crucial

- Disability of an Owner

- Disabled owner needs \$\$ for medical or living expenses
- Healthy owner is now responsible for producing the missing income
- Disabled owner may not be able to sell fractional interest to outsiders – forced to litigate or sell at depressed price




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### Wealth transfer techniques

• **Technique #1: Buy/Sell Agreements**

Why a Buy/Sell Agreement is Crucial

- Irreconcilable Differences or Retirement
  - No way to get out at fair price
  - If the parties cannot agree to a resolution, litigation is the only option
  - May not be able to sell fractional or minority interest to outsiders

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### Wealth transfer techniques

• **Technique #1: Buy/Sell Agreements**

Why a Buy/Sell Agreement is Crucial

- Divorce
  - Business may get allocated to the non-operating spouse in the divorce decree
  - Non-divorcing owner may end up in business with someone they didn't bargain for
  - Important to have the spouse of each owner sign the buy-sell at the outset.

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### Wealth transfer techniques

• **Technique #1: Buy/Sell Agreements**

Types of Buy/Sell Agreements:

- Redemption of Interest by the Entity
- Cross-Purchase Among the Owners
- Hybrid Agreement

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### Wealth transfer techniques

- **Technique #1: Buy/Sell Agreements**  
Entity Buy/Sell Agreement



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### Wealth transfer techniques

- **Technique #1: Buy/Sell Agreements**  
Cross-Purchase Agreement

- Each owner buys a policy on the other. In the Event of death or disability: The policy owner uses the proceeds to buy out the heirs or disabled owner's interest in the business.



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### Wealth transfer techniques

- **Technique #1: Buy/Sell Agreements**  
Hybrid Method

- Several Variations  
- Example – Upon the triggering event, the entity has the option or obligation to purchase the interest of the departing owner; if not exercised, the remaining owners have the option or obligation to purchase.

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### Wealth transfer techniques

● **Technique #1: Buy/Sell Agreements**

**COMPARISON**

*Cross Purchase*

1. Every owner must own a policy on every other owner
2. Younger owners must pay more
3. Sales proceeds taxed at lower capital gains rate
4. Step up in basis

*Entity Purchase*

1. Only one policy for each owner
2. Cost is spread out
3. Sales proceeds may be treated as dividends – C Corp.
4. No step up in basis for owners with C Corp.
5. AMT – C Corp.

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### Wealth transfer techniques

● **Technique #1: Buy/Sell Agreements**

**The Agreement Should Address:**

- Restrictions on the sale of an interest
- Triggering Events – death, retirement, disability, divorce, or termination of employment
- Setting the price
- Funding
- Payment Terms
- Non-compete Provisions

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### Wealth transfer techniques

● **Technique #1: Buy/Sell Agreements**

**Setting the Purchase Price**

- Fixed: a fixed price (adjusted annually by the owners);
- Appraisal;
- Formula: a formula is specified by which a definite price can be determined; and
- “Texas Shoot Out” or Put and Take Method.

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Wealth transfer techniques

● **Technique #1: Buy/Sell Agreements**

Funding the Buy/Sell Agreement

- Life insurance and/or disability insurance is the most common (and usually the most efficient) method of funding the purchase price
- Installment agreement
- Loan from bank

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Wealth transfer techniques

● **Technique #1: Buy/Sell Agreements**

Insurance Must be Coupled with the Agreement

- Insurance with No Agreement
  - Beneficiary of policy might not use the money to purchase the interest – heirs are stuck
- Agreement with No Insurance
  - With no insurance in place to fund the buyout, the business may have to close down or liquidate

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Wealth transfer techniques

● **Technique #1: Buy/Sell Agreements**

Conclusion

- The Buy/Sell Agreement is almost uniformly passed over by many new business owners who are more concerned with profits than providing for their loved ones in the case of catastrophe. This is often the cause of many business failures upon disagreements between owners, and the cause of bigger problems in the case where one party becomes disabled or dies prematurely.

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### Wealth transfer techniques

• **Technique #2: Family Limited Partnerships**

- Family Limited Partnership ("FLP") is a limited partnership established under state law
- There are 2 classes of partners:
  - *General Partner* - Very little economic interest (typically 1%) but virtually all management control
  - *Limited Partner* - Virtually all of the economic interest, but very little management control
- Donor contributes assets to the FLP in exchange for both general and limited partnership interests

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### Wealth transfer techniques

• **Technique #2: Family Limited Partnerships**

- Donor makes gifts of limited partnership interests to next generation.
  - Annual exclusion
  - Unified credit
- Valuation discounts are often taken. The two types:
  - Lack of marketability
  - Lack of management control (minority interest)
- Retention of general partnership interest allows senior generation to retain control while transferring value out of their taxable estate.

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### Wealth transfer techniques

• **Technique #2: Family Limited Partnerships**

- Advantages
  - Discounts
  - Separation between ownership and control
  - Consolidated management of assets
  - Superior asset protection
- Disadvantages
  - Separate entity which requires administration and tax returns
  - General partner has fiduciary duty to limited partners
  - IRS scrutiny

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### Wealth transfer techniques

- **Technique #3: "S" Corp. Recapitalization**
  - What is it?
    - FLP-type technique for "S" Corporations
  - "S" Corporation
    - Cannot be owned by a partnership (FLP not available)
    - Cannot have more than one *class* of stock
  - However, "S" corporation can have more than one *kind* of stock (voting vs. non-voting)

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### Wealth transfer techniques

- **Technique #3: "S" Corp. Recapitalization**
  - "S" Corporation is recapitalized to have:
    - Voting common stock
    - Non-voting common stock
  - Gifts of non-voting common stock are then made to the next generation
  - Discounting available:
    - Lack of Control
    - Lack of Marketability

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### Wealth transfer techniques

- **Technique #3: "S" Corp. Recapitalization**
  - Advantages
    - Discounts
    - Separation of ownership and control
  - Disadvantages
    - Potential premium placed on the voting stock
    - Wealth transfer is not accomplished without additional gifting or other transfer techniques

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### Wealth transfer techniques

- **Technique #4: Intentionally Defective Grantor Trust**
  - Accomplished by selling asset (business interest) to a trust in exchange for an installment note
  - “Freezing” Technique
    - Freeze value of an asset
    - Freeze return on an asset

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### Wealth transfer techniques

- **Technique #4: Intentionally Defective Grantor Trust**
  - Trust
    - Usually children are beneficiaries
    - Defective - income taxes are still paid by grantor
    - Income tax paid on trust income are not additional gifts
  - Sale to trust
    - Business owner receives an installment note
    - No capital gain on sale
    - Installment obligation is paid through income received by trust

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### Wealth transfer techniques

- **Technique #4: Intentionally Defective Grantor Trust**
  - Advantages
    - No income taxes on sale to trust
    - Payment of income taxes on trust does not create additional gift
    - Trustee can control timing and amount of distributions to beneficiaries
  - Disadvantages
    - Cash flow may be insufficient to pay installment obligation
    - Seller’s estate will include balance of outstanding note
    - Undistributed trust income is subject to higher trust tax rates when trust is no longer defective

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## Business succession planning

- **Summary**

- A number of techniques exist to minimize estate tax exposure while achieving owner's wishes
- A number of factors influence the choice of which technique is appropriate
- Whichever technique is used, it should be part of a comprehensive financial and estate plan

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## Final Thought

**Not only do your clients who own businesses need to address their business succession needs... but, it may be time for you to start thinking about what might happen to *your* business if you can't go to work some day.**

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