Striking a Balance: Aligning the Business Succession Plan With the Estate Plan

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Profile of E. John Wagner

E. John Wagner is a Board Certified Tax Attorney at Williams Parker and chairs the firm's Corporate and Tax Practices. He represents executives, entrepreneurs, and real estate investors in tax, transactional, capital raising, estate planning, and estate administration matters. He obtained his Master of Law in Taxation from the University of Florida.

Profile of Douglas Elmore

Doug is a trusts and estates attorney. He focuses on helping families develop personalized, tax-efficient wealth transfer plans using current estate planning methodologies. He counsels clients on customized beneficiary designations for IRAs and other tax-deferred investment accounts.

Doug also handles especially complex estate administrations. He has substantial experience in preparing Form 706's, administering trusts and estates consisting of closely held businesses, and implementing complex post-mortem planning techniques.

Doug recently served as Assistant Editor the Florida Bar's Tax Bulletin.

Getting Started: Plan Your Business's Succession

- Business succession planning is the process by which business owners determine the manner in which new management and ownership will replace current management and ownership.
- It can take many forms:
  - Address a near-term change in control, ownership, or management.
  - Plan a transition far into the future, but still include plans to keep the business alive in the event of an unexpected death or disability, which could lead to the erosion of the company's core principles.

Getting Started: Set Goals Based on the Status and Needs of Your Business

- Start-up - Protect against the unexpected.

- Mid-stage, mid-career
  - See the exit
  - Position Yourself for an exit while still protecting from hazards

- Mature – Execute the exit

Getting Started: Connect Goals with Tools

- Start-up
  - Management depth and cross training
  - Buy-sell agreements
  - Appropriate insurance arrangements
- Mid-stage, mid-career
  - Maintain and modify start-up arrangements
  - Considers structures to optimize growth
  - Consider structures to protect current owners while positioning to reduce future estate tax and other taxes
- Mature – Complete the pre-planned exit

Getting Started: Don't Let Mumbo Jumbo or One-Solution Approaches Beat You

- Business succession terminology is confusing, but the solutions are understandable.

- Different solutions fit different people and different businesses. Life and disability insurance, trusts, gifting and other tools—along or in combination with each other--are a good fit for some, but not others.

- Know what you really need, and the right solution will present itself.

Coordinating the Business Succession Plan with the Estate Plan

- Business succession in context of estate plan
- Example
- “Some basic ground rules”

Meshing the Plans

- Many of the same techniques:
  - Annual exclusion or
  - lifetime gifts
  - Sales
  - ILITs/Life Insurance
  - GRATs
  - Lifetime QTIP Trusts
  - FLPs
  - IDGTs
  - Spousal Lifetime Access Trusts or "SLATs"
  - Private annuities
  - Charitable giving

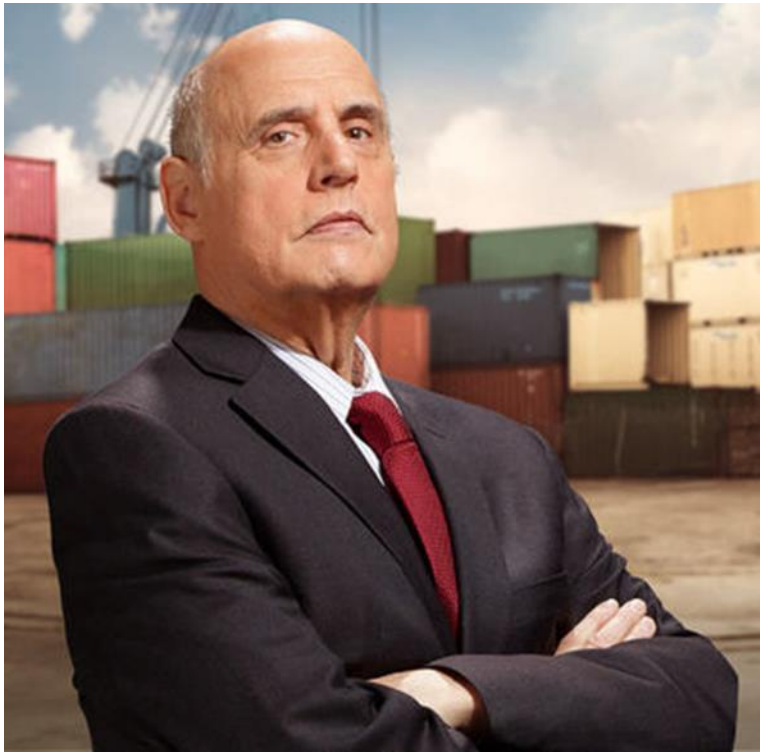
Meshing the Plans (Cont'd)

- Business owner techniques and considerations:
  - Recapitalizations
  - Buy-sell agreements
  - IRC Section 6066
  - ESOPs

The Booths

The Booths

George Booth, Sr., Age 70



Lucille Booth, Age 70

The Booth Children

- Gob, age 43
- Lindsay, age 41
- Michael, age 40
- Buster, age 35

The Booths – Asset Mix

- Homestead
  - FMV = $1,000,000
- Cash & Marketables
  - FMV = $6,000,000

- The Booth Company, Inc.
  - Active business
  - Sole owner = George
  - Sole director & officer = George
  - FMV = $6,000,000
    (minimal appreciation)

The Booth Company, Inc.

- Consistent cash flow
- S corporation
- 100 voting shares, action by majority vote
- Michael is the middle son and the natural successor

Estate Plan and Tax Attributes

- Traditional A-B Plan
- No lifetime gifts → $5,450,000 of applicable exemption per spouse

Example One

LIFETIME TRANSITION TO MICHAEL

The Booths Long Term Goals

- Effective transition of management and ownership
- Tax planning
- Equalization of estate
- Limiting involvement of other children in business

The Plan – Lifetime Transition to Michael

- Transfer a minority interest to Michael
- Sell a minority interest to Michael
- Retain a significant minority interest
- Transition timeline = 3 years
- Governance = elevate Michael
- Buy-sell agreement

The Plan – Lifetime Transition to Michael (Cont'd)

- Terms and conditions of sale:
  - 100% financing via secured note
  - Note and Security Agreement featuring "claw back" control
  - Continuing compensation
  - Continuing involvement as director and/or officer

The Plan – Lifetime Transition to Michael (Cont'd)

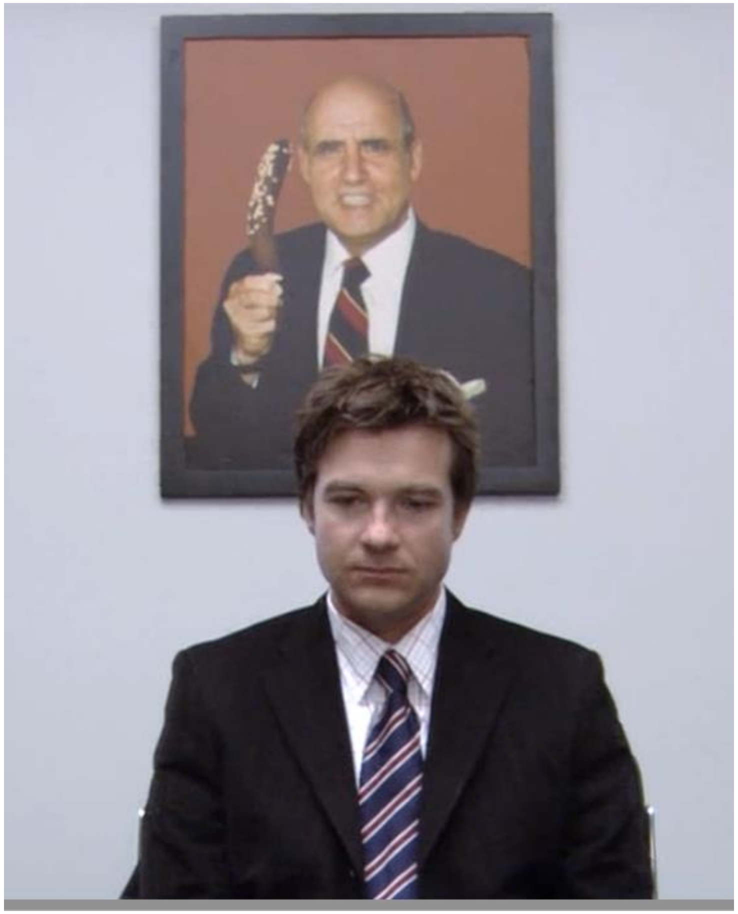
- Update estate plans
  - Specific bequest of remaining shares to Michael
  - Funding language regarding promissory note
  - Tax apportionment

Implementing the Plan

- Annual gifting
  - 2014
    - .467 of a share, $28,000 NAV
  - 2015
    - $28,000 cash gift
  - 2016
    - $28,000 cash gift

Implementing the Plan (Cont'd)

- Transferring control
  - 2016 = George sells 49.633 shares to Michael, giving him actual control
  - George retains 49.9 shares



Implementing the Plan (Cont'd)

- Controlling interest of 50.1 shares:
  - 49.63 shares via purchase
  - .467 share attributable to 2014 gift
- George retains 49.9 shares

Implementing the Plan (Cont'd)

- Terms of Purchase
  - Purchase price of $2,233,500
    - $6,000,000 x .49633 = $2,977,800
    - $2,977,800 x .75 = $2,233,350
      - .75 represents 25% discount for lack of marketability and lack of control (see e.g., *Estate of Bright* and TAM 9432001)
  - Term = 9 years
  - Interest Rate = 1.43%

Operation of Estate Plan

- Assume that George and Lucille die simulateneously

Operation of Estate Plan (Cont'd)

- George's Gross Estate = $11,479,000:
  - –Residence = $1,000,000
  - –Cash and investments = $6,000,000
  - –Promissory Note = $2,233,500
  - –49.90% minority interest in TBC = $2,245,500

Operation of Estate Plan (Cont'd)

- George's Gross Estate assuming no transfers = $13,000,000:
  - Residence = $1,000,000
  - Cash and investments = $6,000,000
  - 100 shares of TBC = $6,000,000

Operation of Estate Plan (Cont'd)

- Federal Estate Tax Computations
  - Tax due if no transfers:
    - ($13,000,000 - $10,900,000) x 40% = $840,000
  - Tax due if transfers:
    - ($11,479,000 - $10,900,000) x 40% = $231,600

Operation of Estate Plan (Cont'd)

- Tax Savings
  - $840,000 tax due if no transfers
  - $231,600 tax due if transfers made
  - Net Savings = **$608,400**

Operation of Estate Plan (Cont'd)

- Closer to achieving equalization if transfers occur
  - George's 49.9 TBC shares to Michael
    - Net asset value = $2,994,000
    - Value on Form 706 = $2,245,500

Operation of Estate Plan (Cont'd)

- Michael gets 49.9 shares of TBC
  - Net asset value = $2,994,000
  - Value on Form 706 = $2,245,500
- Other 3 children get assets valued at $3,000,633.33:
  - $333,333.33 = 1/3 of homestead
  - $2,000,000 = 1/3 of liquid assets
  - $744,500 = 1/3 of note from Michael
  - ($77,200) = 1/3 of tax to residue

Operation of Estate Plan (Cont'd)

- Equalization fails if transfers don't occur
  - Michael gets all 100 shares of TBC, valued at $6,000,000
  - Other 3 children receive assets valued at $2,053,333.33,000
    - $333,333.33 = 1/3 of homestead,
    - $2,000,000 = 1/3 of liquid assets, and
    - ($280,000) = 1/3 tax to residue

Summing it Up

- Lifetime transfer of control to Michael → preservation of value
- Tax planning via minority interests
- Equalization of estate, based on NAV
- Limited the involvement of other children in business

Other Planning Options

- Sale to IDGT rather than directly to Michael
- Using a GRAT to transfer minority interests to Michael during period prior to sale
- Commercial loan to "cash out" George
- Further equalization via life insurance or ILIT

Example Two

POST-DEATH SALE

Fact Pattern Changes

- George and Lucille are 60 rather than 70
- None of the children are currently involved in the business or desire to be involved in the business →
- Michael used to be involved and is still intimately familiar with business
- Business valued at $15,000,000

The Booths Long Term Goals

- Flexibility as to management and control of the business
- Tax planning
- Equalization of estate
- Preserving estate liquidity

The Plan – Post-Death Sale

- Transition timeline = none
- "Safety Net" succession planning via management succession committee
- Annual resolution regarding successon

The Plan – Post-Death Sale (Cont'd)

- Structure a recapitalization between voting and non-voting shares → segretate value and control
- Transfer non-voting shares to Lucille
- Buy-sell for "drag along" rights

The Plan – Post-Death Sale (Cont'd)

- Update estate plans
  - Voting shares held in credit shelter trust or marital trust? QTIP Business Marital Trust
    - *Bonner* and *Mellinger* cases
  - Name Michael as successor trustee of George's revocable trust
  - Michael as Trustee of QTIP Business Marital Trust

The Plan – Post-Death Sale (Cont'd)

- Update estate plans (cont'd)
  - Statement of intent that successor trustee facilitate management succession, per corporate resolution
  - Establish a mechanism to sell the shares → required sale versus intended sale

The Plan – Post-Death Sale (Cont’d)

- Balance of assets
  - Outright to surviving spouse
  - Disclaim to disclaimer trust
- Distribution following death of survivor
  - Specific distribution or equal shares
- Tax apportionment

Implementing the Plan

- Appoint management succession committee and define responsibilities → George and Michael = initial members
- Recapitalize TBC (10-90 split)
  - $1,500,000 of net asset value attributable to 10 voting shares
  - $13,500,000 of net asset value attributable to 90 non-voting shares
  - Valuation discount applies to non-voting

Implementing the Plan (Cont'd)

- Recapitalize TBC (Cont'd)
  - Under Section 1360 regulations, the recapitalization does not cause the S Corporation to have 2 classes of stock
  - Generally income tax free under Section 368(a)(1)(E)
  - Non-voting shares may qualify for discounts based on lack of control and lack of marketability

Implementing the Plan (Cont'd)

- Valution discount applicable to non-voting shares
  - $13,500,000 of net asset value x .75 = $10,125,000

Operation of Estate Plan

- Assume that George dies first

Operation of Estate Plan (Cont'd)

- George's Gross Estate = $8,000,000:
  - –Residence = $500,000
  - –Cash and investments = $6,000,000
  - –Voting shares of TBC = $1,500,000 (assuming no control premium)

Operation of Estate Plan (Cont'd)

- Federal Estate Tax
  - No tax due:
    - $1,500,000 to QTIP Business Marital Trust → qualifies for marital deduction
    - Balance of assets outright to Lucille → transfers qualify for marital deduction
  - Form 706 for Portability

Operation of Estate Plan (Cont'd)

- Control of sale:
  - Michael calls the shots regarding a sale by the administrative trust
  - Michael calls the shots regarding a sale by the QTIP Business Marital Trust

Operation of Estate Plan (Cont’d)

- Assume further that Lucille dies following George’s death, still owning business
- Lucille’s Gross Estate = $18,625,000:
  - –Residence = $1,000,000
  - –Cash and investments = $6,000,000
  - –Non-voting shares = $10,125,000
  - –QTIP Business Marital Trust = $1,500,000

Operation of Estate Plan (Cont'd)

- Federal Estate Tax Computations
  - Tax due of 3,090,000:
    - ($18,625,000 - $10,900,000) x 40% = $3,090,000

Operation of Estate Plan (Cont'd)

- Estate Tax Savings
  - $13,500,000 net asset value of non-voting shares - $10,125,000 discounted value of voting shares = $3,375,000 in value excluded
  - $3,375,000 x 40% = $1,350,000
  - Savings = **$1,350,000**

Operation of Estate Plan (Cont'd)

- Equalization
  - Facilitated via split between voting and non-voting shares
  - Even if voting shares transferred to one of 4 children, $1,500,000 is much less of a preference than $15,000,000

Summing it Up

- Flexibility
  - Mechanism in place to make future decisions
  - May sell after death of George or death of Lucille (buy-sell “drag along” rights)
  - Michael has the right to sell business during Lucille’s life and prior to final distribution of QTIP Business Marital

Other Planning Options

- Management succession
  - Michael’s involvement /committee involvement could instead arise upon George’s death
  - George could’ve expanded committee to include other family members and non-family members

Other Planning Options

- Estate Planning
  - Credit shelter trust instead of QTIP Business Marital Trust (if future appreciation)
  - Fractionalize voting shares between spouses
  - FLP for further discount planning → could be funded with non-voting shares and outside assets
  - Consider sale to ESOP
  - Zero-out federal estate tax via charitable bequest

How Do I Plan for Succession of a Family Business?

1. **Start as early as you are able. A well-planned business succession plan can take 5 to 20 years or more to fully develop and implement.**
2. **Consider a business advisory or oversight committee.**
3. **Openly discuss each child's potential role and have a family meeting or series of meetings to discuss such roles.**
4. **Establish your future retirement income independently of the business.**
5. **Identify key employees.**
6. **Be realistic. Just because they are your children does not mean that they are the most capable of running a business.**
7. **Consider liquidity needs, estate taxes and operations of the business in your absence.**
8. **Review shareholder agreement or other underlying governance documents.**
9. **Review terms of any loan documents for conditions of default.**
10. **Section 6066 – Internal Revenue Code.**

Thank You!

- Disclaimer: This presentation is for general informational purposes only. It shall not be construed to contain legal advice or establish an attorney client relationship with any individual. Please consult with your estate planning attorney for specific advice tailored to your personal facts and circumstances.
- Questions?
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Thank you