# Considerations and Instruments for Effective Succession Planning

or

Steps for Ensuring Your Clients' Companies Won't Die When They Do

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No one wants to plan ahead. Planning is time consuming, not fun, does not reap immediate results and as many have discovered, can fall apart at the last moment leaving the planner with no good option. Even so, more often than not, it pays off. If this is true, then why are so many Small Business Owners ("SBOs") reluctant to think ahead about an exit strategy – especially when they plan daily for their business operations and have first-hand knowledge of the benefits? SBOs start their businesses with a dream, work diligently to move that business forward towards profitability – sometimes creating long-term strategies. Then one day, at the age of 65, they start thinking about an end game and they envision implementing it in the next two years. How does the vision become near-sighted?

The difference is in what results from the planning. While business planning focuses on building, expanding and growing, succession planning necessarily plans for the end; the end of a reign, the end of an era, the end of a life - or maybe not. SBOs need assistance in changing their focus to creating an opportunity which will move the business into the next phase and build a legacy for the future. With encouragement to plan ahead, guidance through lingering myths and issues, and direction as to implementation of the techniques available, professionals provide a valuable resource for their clients…a resource that is definitely needed.

Family businesses account for about 50% of the Gross Domestic Product of the U.S. Beyond that, 35% of Fortune 500 companies are private or public companies controlled by families – and they didn't start out as Fortune 500 companies. Small businesses contributed 55 percent of the 12.2 million total net job creation across all firm sizes from 2013 to 2023 in America[1] and

[1] U.S. Bureau of Labor Statistics: https://www.bls.gov/opub/ted/2024/small-businesses-contributed-55-percent-of-the-total-net-job-creation-from-2013-to-2023.htm#:~:text=Since%20the%20first%20quarter%20of,creation%20across%20all%20firm%20sizes. (last updated May 1, 2024)

employ 61.6 million people making up 45.9 percent of all U.S. employees as of 2023.[2] We all know it and the data supports it - family owned businesses are the back-bone of the United States. And, given the size of the majority of small family-owned businesses, one might consider the planning to be fairly simple. The business simply passes from the first generation to the next. We all can picture it in our minds: Dad and Mom, who started the business in their garage…or basement…or backyard, flanked by their three loving, well-adjusted children, all of whom are involved in the business (and who, by the way, are not on drugs and have no prison records), love the business and want to see the business thrive for another 50 years. There are no ugly, meddling, hateful spouses. The grandchildren are all helpful and willing to play their part. The children would never, ever consider selling the beloved business. It seems perfect.

**STRATEGIC PLANNING IS WORTHLESS UNLESS THERE IS FIRST A STRATEGIC VISION. – JOHN NAISBITT**

**A Good Succession Strategy Requires Planning**

Unfortunately, our minds are where that picture will always reside. Leo Tolstoy in his book Anna Karenina states, "Happy families are all alike; every unhappy family is unhappy in its own way." Each family is different and as any parent will tell you – no two children are alike. The chances are slim that all the children in a family will want to work in the business or even ensure that the business will continue. Many SBOs are parents and they know this. In fact, according to the Harvard Business Review, about 70% of small businesses will not make it to the second generation and when you look at the third generation, a mere 10% continue to be passed down.[3] Whether it's an aptitude, experience or an interest issue, the failure rate is concerning.

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[2] USA Today: https://www.usatoday.com/money/blueprint/business/business-formation/small-business-statistics/#:~:text=These%20figures%20also%20show%20that,U.S.%20employees%20as%20of%202023. (last updated June 18, 2024)

[3] Harvard Business Review: https://hbr.org/2012/01/avoid-the-traps-that-can-destroy-family-businesses

It's up to professionals to help SBOs identify their goals, identify the familial issues that may create problems and utilize the myriad of techniques available to protect the SBO and implement an exit strategy – whether that means transferring ownership to the next generation, or not. The American Institute of Public Accountants has created a checklist (included as Exhibit 1) to aid professionals in ensuring that all potential areas of concern have been addressed.

So, how do we, as professionals, change the traditional mindset of the SBO? There are multiple barriers and the first is the myths that SBO's rely on; and, whether they're relying on these myths consciously or not, the reliance impedes a change in focus. Some of them are the same myths that plague individuals who don't want to get started with an estate plan. The first step is showing the SBO the problems with these myths.

- I have plenty of time for planning later.
- A successor will be ready when I'm ready.
- Equal is the same as fair.
- If I give up ownership, I'll lose control.

*I Have Plenty Of Time For Planning Later:*

What has always intrigued me is the number of individuals in their 70s that will say this. Admittedly, convincing someone to pay for a service that he or she may never see the benefits of can be a difficult task. Just ask any estate planning attorney. Although this myth is easily refuted logically, we all know that what is in the head is not always communicated to the heart. No one wants to contemplate death. My parents' estate planning has been completed for years, but they still refuse to buy their burial plots. It's just too much. There are all kinds of reasons why, but it really boils down to being just plain morbid. The best way to communicate urgency to the SBO is to remove them from the picture. Focus instead on the burden, especially the potential taxes, their surviving family members will be facing if they don't implement a business succession plan now. Many of the SBOs we encounter are older and are just now focusing on their estate planning. They can understand the idea of a probate. When they discover that their business may not just automatically pass down if they own 100% of it in their name, SBOs become much more willing to plan.

*A Successor Will Be Ready When I'm Ready:*

Oh, if it were only this simple. Poof! A successor is born. The reality is that grooming has to take place and this myth assumes that the SBO will be around to facilitate the transfer. Successor owners don't just happen. It takes planning and communication especially with regard to family members. This myth also assumes that only one successor will be ready and willing. That's not always the case and implementing the "eeny meeny miny mo" method of selection is not the answer. Again, a professional can help shift the focus of the SBO to the individual who will be the successor. Communication is the key. The successor needs to have training and guidance and some kind of idea of when and how the transfer will take place.

*Equal Is The Same As Fair:*

This is a big problem in family owned businesses where often times the bulk of the inheritance for the heirs is associated with the value of the business. Simply splitting the ownership up between the children equally is not always the right or fair answer. This is especially true when one or more children are heavily involved in the day to day operations and other children don't have the aptitude, experience or interest necessary to be involved. Only one-third of all family businesses successfully make the transition to the second generation[4] and equal distribution of

[4] Michael Evans, *5 Steps to Create a Viable Succession Plan For Your Family Business*, http://www.forbes.com/sites/allbusiness/2013/08/28/5-steps-to-create-a-viable-succession-plan-for-your-family-business/#7383aca55248 (last updated August 28, 2013)

ownership to unqualified children is one of the reasons why. There are planning techniques that should be shared with the SBO that allow all the children to receive value from the family-owned business while allowing only those children who are willing and who should be managing the company to do so. Some of these techniques include separating out parts of the business into other companies. Goodwill of the owner can be segregated as well as the real estate and equipment used in the business.

*If I Give Up Ownership I'll Lose Control:*

This myth comes from a place of fear. For many SBOs their company is just one more child. They created it from nothing, they built it into something and no one, I tell you no one, will do as good a job managing it as they do. So, who would want to turn over ownership of their business to the next generation, only to see them mismanage it and run it into the ground? The key to debunking this myth is to show the SBO that ownership and control do not have to be given up in order to implement a succession plan. This transfer does not have to happen all at once and it most certainly is not an "all or nothing" proposition. Providing the SBO with solutions that meet the need and desire to stay involved will help to eliminate the fear and begin the construction and implementation of a plan.

## "I DON'T THINK ANYONE HAS A NORMAL FAMILY" – EDWARD FURLONG
### Family Dynamics In Succession Planning

Three of the four myths discussed above can affect all SBOs because they focus on delay and procrastination. However, those in family-owned businesses have an added component of family relationships and other issues beyond the business including underlying dynamics that, sometimes, have never been addressed or mentioned. Estate planning attorneys face these issues everyday; couples who have never discussed the child that was given up for adoption, Johnny and his drug problem, or the discontent among their children that has existed for years. There is one family that exists before a death, and wholly new one that emerges after a death. In our office, we refer to it as the "mom loved you best" mentality. While I would never suggest that a professional attempt to play the role of therapist, we must all be aware of the family dynamics at play and recognize the sensitivity that must be applied when working toward resolutions that will allow for the continuation of the family-owned business into the next generation. Various questions will emerge during the planning process based on family dynamics, such as:

*Taxes and Court Procedures* – What kind of structure is best for mitigating estate taxes and avoiding probate?

*Transfer Ability/Assumptions* – Can the first-generation owner actually let go of control of the business? If so, are the children really interested in taking over the company? Or, are there just familial assumptions that have been made about succession. If the children take over, what kinds of changes will they wind up making?

*Continued Income for SBO* – If the SBO desires to turn over the reins to a new generation, can he or she do that? What kind of need does the SBO have for the continuation of income into retirement?

*Disputes* – Are adequate corporate documents in place such as buy/sell agreements? How is equality vs. merit measured, (i.e., compensation of family members who actually work in the business)? SBOs also must plan for other issues that most families will face at some point, such as the divorce of a child. Adequate planning is as much about keeping an inheritance from those who should not receive it as it is about making sure it passes to those who do. Additionally, with the high occurrence of blended families, there is always the possibility that a surviving spouse who is not related by blood could wind up holding stock unless proper corporate documents are in place. These issues create a ripe environment for estate and trust litigation.

## "HE WHO COMES FOR THE INHERITANCE IS OFTEN MADE TO PAY FOR THE FUNERAL" – YIDDISH PROVERB
### Estate Planning As Part Of The Overall Succession Strategy

Estate planning is an integral part of building a successful succession strategy. I'm not referring to the core estate planning documents (will, trust, financial power of attorney, healthcare power of attorney, healthcare directive) although I would argue that each of those documents are necessary. The estate planning strategies that need to be contemplated with a family owned business involve considerations of equalized interests, gifting, corporate structure, transfer of ownership and capturing intangible assets that are often lost.

Although all of the above are important, equalization of ownership among children in a family can be most difficult especially when one child is significantly involved in the business and others are not. The approach most often contemplated by SBOs is that the son or daughter who is involved will buy out the SBO and sometimes that is a solution that works. However, for some families, there are no other significant assets owned by the parents. The business is the legacy and the inheritance, and ideally, they would like all of their children to have a part in moving it forward.

With regard to the other goals of gifting, corporate structure and capturing intangible assets, Exhibit 2 shows an example of some of the structures used to pass a business onto the next generation and transfer assets through gifting, thereby accomplishing these goals.

*Intentionally Defective Grantor Trusts (IDGT).*

I always thought that this acronym was funny as it was what I used to call someone who was not using all of their brain capacity. However, it follows a standard in estate planning circles that all kinds of trusts have acronyms to describe them. As Samuel Donaldson said at the

Heckerling Estate Planning Conference in 2013 - and I'm paraphrasing, "There are CRATs and CRUTs, CLATs and CLUTs and we have SLATs, but currently no SLUTs." It's a humorous truth. If there's a trust vehicle for estate planning that exists, it will most likely have an acronym associated with it. An IDGT allows the grantor to transfer assets out of his or her estate, but still pay the income taxes generated by the asset thereby allowing the grantor to move assets out of his or estate and to the next generation in order to reduce the potential for estate taxes on the grantor's estate. However, with such a high federal exemption amount (currently at $13.61 million), this strategy may only be an option for wealthier clients. Regardless, for those clients, this vehicle, when coupled with a sale of an asset into the IDGT (especially an asset with a low basis) and the use of a Self-Cancelling Installment Note (SCIN), this tool can effectively remove assets from the estate of the grantor, create a revenue stream for the grantor and eliminate the burden of the taxes from the beneficiaries of the trust (essentially creating a gift). There are several common provisions that can create an intentionally defective grantor trust for income tax purposes.

- Substitution of Assets: The grantor is given the power to reacquire trust assets by substituting assets of equivalent value. *See* Rev. Rul. 2008-22, 2008-16 I.R.B. 796.
- Loans: Either the actual borrowing of funds by the grantor or spouse without adequate interest or adequate security or the power held by a non-adverse trustee to make loans to the grantor or spouse with adequate security. *See* §675(2) of Internal Revenue Code.
- Power of Disposition: Giving power to the trustees (when more than half of them are related or subordinate) to sprinkle or accumulate the income or principal of the trust that is not subject to a reasonably defined standard. This is defined as an ascertainable standard (health, education, maintenance and support). *See* Reg. §1.674(b)-1(b)(5)(i).

- Addition of Beneficiaries: Giving the grantor or a non-adverse party a power of disposition that affects the beneficial enjoyment of the trust corpus or income. *See* §674(a) of Internal Revenue Code.
- Spouse as a Beneficiary or Powerholder. If the income of the trust can be distributed for the benefit of the grantor's spouse or if the grantor's spouse holds certain powers, the trust will be treated as a grantor trust.

*Corporate Structure:*

Long before the introduction of the LLC, there was the C-Corporation. Now sometimes considered an archaic structure, with its double taxation and cumbersome corporate procedures, the C-Corporation used to be the only deal in town. So, don't be shocked if your client has been operating for 25 years under that model. When creating alternative structures moving forward, it may be beneficial to consider effectively transferring the operations into a more flexible structure such as an LLC which can be taxed as either a partnership or an S-Corporation. However, be careful with regard to making a change. There can be significant tax implications for the business resulting from issues, such as:

- Built In Tax Gains: These gains are taxed at the highest corporate tax rate (currently 21%) on appreciated property. If an S-Corporation that was previously a C-Corporation sells an asset that has appreciated in value and that appreciation occurred while the company was a C-Corporation, the S-Corporation may pay C-Corporation taxes on the value of the appreciation even though the corporation is now an S-Corporation. The most common asset affected by this is goodwill of the corporation.
- Passive Investment Income: S-Corporations are subject to a tax if they were previously a C-Corporation and if their passive investment income (i.e., dividends, interest, rents, and

royalties) exceeds 25% of their gross receipts and the S-Corporation has accumulated profits carried over from the years in which it was a C-Corporation.

- Untaxed Profits: If profits were created before a company converted from a C-Corporation to an S-Corporation, they may generate income tax. The most likely scenarios involve accounts receivable or appreciated real estate.
- Inventory Methods: If a C-Corporation uses the LIFO inventory method, there will be tax on the benefits derived by using LIFO when it is converted to an S-Corporation.

There are instances, when the best decision is to leave the C-Corporation in place and create new entities that work with it to mitigate negative tax effects.

*Goodwill:*

As a young accountant, I can remember this word being discussed, mostly in terms of amortization and how quickly it could happen. It always appeared in situations of corporate buyouts and seemed rather intimidating at first glance. Over the years, I've learned that it can be a great way to allocate value. In the attached Exhibit 2, the goodwill generated by the father has been separated out and utilized to generate continued income.

Calculating goodwill is done through a business valuation. Some SBOs are reluctant to spend additional funds to value their company. As with any client interaction, the key is to increase communication and to help the client understand how this part fits into the larger picture. Additionally, there are two different types of goodwill. The first is goodwill that the company has. For example, Apple is a brand and the name itself, sends a message. Based on the currently sales of their products, the name alone generates business. That goodwill stays with the company. The second type of goodwill is personal goodwill. That is the goodwill that comes with an individual and it can't be separated from who that person is. If the father in a family started the business and now all of the customers bring their business to the company because of the father, that is his personal goodwill. That personal goodwill can be valued, separated out from the company and used for structuring a succession plan.

*Management Company:*

Earlier we discussed equalization for children and the utilization of a management company as one way in which to accomplish this. One strategy is to have a management company owned by the children who will be running the daily operations. They can also have an interest in the original company which will be owned by all of the children. With this structure, all of the children can have an ownership interest in the ongoing business, but not necessarily be involved in the day to day activities. The management company can then enter into a negotiated contract with the family business that provides compensation for the efforts of those children who ensure that the business continues and is successful.

*Service Agreements:*

For first generation SBOs, the idea of giving up the ownership of the company is a difficult prospect to face. However, the company can enter into service agreements with the SBO which will allow him or her to continue to be involved on an agreed basis that is defined in the scope of the agreement. These agreements can be constructed for a limited amount of time so that the first-generation owner can phase out his or her involvement in the company – on his or her own terms. This is also an excellent strategy if the first-generation owner has a significant value in his or her personal goodwill.

## GOOD FORTUNE IS WHAT HAPPENS WHEN OPPORTUNITY MEETS WITH PLANNING. – THOMAS ALVA EDISON

### And In Conclusion…

Building a business is not easy and attempting to figure out how to keep it alive even after the death of the original owner is a definite challenge. This involves balancing the desires of the SBO for retirement and economic safety against the, all too often, dysfunctional dynamics of family. However, professionals must take reluctant SBOs by the hand and explain the advantages of planning ahead. By eliminating the myths and understanding the goals of the client, a professional can help develop a plan that will mitigate the risk of business failure at the hands of the next generation.

# BUSINESS AND SUCCESSION PLANNING

## APPENDIX 7: Succession Planning Checklist

This checklist is to assist closely held businesses in planning for ownership and management succession well in advance of those events.

| | | Key Action Item | Yes | No | Done by or N/A | Comments |
|---|---|---|---|---|---|---|
| 1 | **Evaluate the need for planning:** | | | | | |
| | a. | Owner planning retirement but has no successor? | | | | |
| | b. | Is the designated successor no longer interested or available? | | | | |
| | c. | Does the designated successor need further training to operate the business effectively? | | | | |
| | d. | Have owner's retirement plans changed creating a need for a new plan? | | | | |
| | e. | Does the designated successor lack financial resources required by the owner, thus requiring a new plan? | | | | |
| 2 | **Prepare a business valuation:** | | | | | |
| | a. | Consider industry rules of thumb valuations? | | | | |
| | b. | Does owner have realistic expectations for value of their business? | | | | |
| 3 | **Understand the business' profitability:** | | | | | |
| | a. | Can cash flow support both owner and successor during transition? | | | | |
| | b. | If not, can successor supplement income with other earnings during transition? | | | | |
| 4 | **Evaluate the owner's goals and concerns:** | | | | | |
| | a. | Identify the advantages and disadvantages of any specific ideas about succession. | | | | |
| | b. | Has the owner considered how co-owners or involved family members feel about such ideas? | | | | |
| | c. | Has the business operated under a formal business plan? | | | | |
| | d. | Is there a buy-sell agreement with co-owners that specifies buy-out terms? | | | | |
| | e. | Does the owner have a manageable timetable for succession? | | | | |
| | f. | Discuss with the owner possible challenges and fears in transitioning leadership: | | | | |
| | | - a loss of business identity? | | | | |
| | | - reluctance to let go of leadership? | | | | |
| | | - fear of retirement boredom? | | | | |

| | Key Action Item | Yes | No | Done by or N/A | Comments |
|---|---|---|---|---|---|
| | - financial insecurity after retirement? | | | | |
| 5 | **Consider competing goals of owner's children:** | | | | |
| a. | Are there children who will not succeed in management? | | | | |
| b. | How will wealth be divided among active and inactive children? | | | | |
| c. | Has owner communicated this reality to each family member? | | | | |
| d. | Are there nonbusiness family issues that would inhibit selecting a suitable family member to succeed the owner? | | | | |
| | - physical, mental illness or addictions? | | | | |
| | - sibling competition or conflict? | | | | |
| | - lack of interest among children? | | | | |
| 6 | **Integrate family succession plan into overall estate plan:** | | | | |
| a. | Are all family members involved in developing and implementing a plan? | | | | |
| b. | Will the transfer be a sale, gift or bequest? | | | | |
| c. | Does the plan define the time frame for the transfer and transition? | | | | |
| d. | Does the plan define the responsibilities of the parties involved? | | | | |
| e. | Does the plan define the mechanics of the ownership change (e.g., stock or title transfer) | | | | |
| 7 | **Will assets be transferred to children?** | | | | |
| a. | Can non-business assets, such as investments, real estate or life insurance be transferred to uninvolved children? | | | | |
| b. | Will quasi-business assets, such as business real estate be transferred to uninvolved children? | | | | |
| | - if so, consider long term lease to prevent disagreements among siblings. | | | | |
| 8 | **Do asset transfers involve gifts to family members?** | | | | |
| a. | Can annual gift exclusions be used to avoid taxable gifts? | | | | |
| b. | Will spouses consent to gifts? | | | | |
| c. | Can a self-canceling installment note (SCIN) be used to transfer assets to a greater extent than the gift tax exclusion allows? | | | | |
| 9 | **Consider whether a trust or family limited partnership should be used to transfer assets:** | | | | |
| a. | Are there fractional interests in property to be transferred? | | | | |
| b. | Can valuation discounts be used in transfers to an FLP for minority ownership and control interests? | | | | |
| | | | | | |

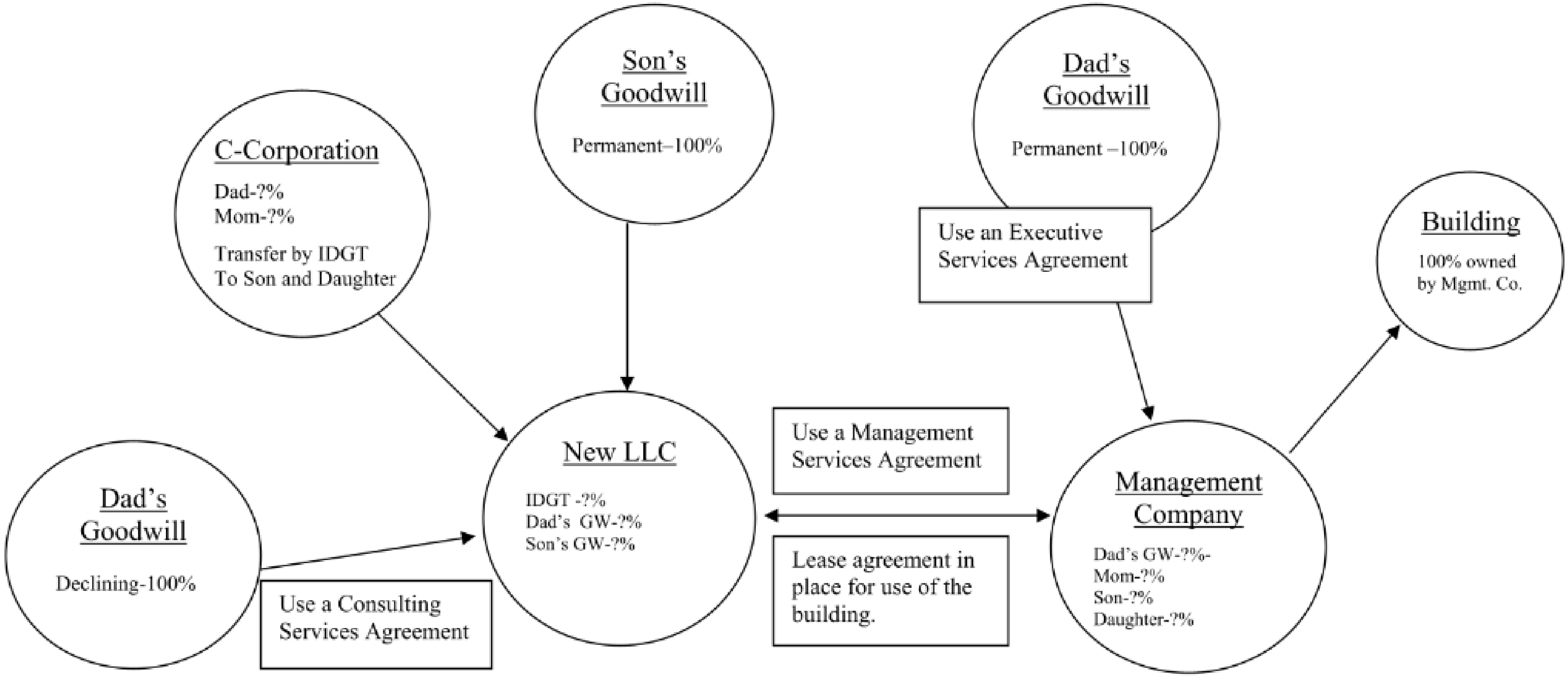
| | | Key Action Item | Yes | No | Done by or N/A | Comments |
|---|---|---|---|---|---|---|
| | c. | Are the terms of the FLP so restrictive as to prevent limited partners from enjoying current benefits of ownership? | | | | |
| 10 | **Is the business already organized as a corporation?** | | | | | |
| | a. | Can transfers of stock be made to all children? | | | | |
| | b. | Will voting control (>50% of voting stock) be retained to take valuation discounts on transferred stock? | | | | |
| | c. | Should the corporation redeem the owner's stock at retirement in exchange for cash or notes? | | | | |
| 11 | **Will business be sold to key employees?** | | | | | |
| | a. | Do employees have financial resources to acquire the business? | | | | |
| | b. | Do employees have management capabilities? | | | | |
| | c. | Can a leveraged buy-out be used to finance the transaction by debt that is secured by the business assets or stock? | | | | |
| | d. | Evaluate whether to sell to employees through an ESOP. | | | | |
| | | - longer time frame to transfer ownership. | | | | |
| | | - company obligated to repay ESOP debt. | | | | |
| | | - Other employees may wish to sell their ESOP stock upon retirement. | | | | |
| | | - annual appraisal required for ESOP. | | | | |
| 12 | **Can business be retained by hiring new management?** | | | | | |
| | a. | Consider retaining ownership if value of company expected to increase significantly. | | | | |
| | b. | Consider creating board of directors to provide leadership and vision. | | | | |
| 13 | **Other alternatives to succession:** | | | | | |
| | a. | Consider sale or merger with an outsider? | | | | |
| | b. | Consider liquidation of company? | | | | |
| 14 | **Communicating the plan:** | | | | | |
| | a. | Is the succession plan in writing? | | | | |
| | b. | Does it contain milestone dates for actions? | | | | |
| | c. | Does the plan contain specific measureable actions each year until the owner's retirement? | | | | |
| | d. | Does the plan reiterate the owner's goals and objectives? | | | | |
| | e. | Have the decisions been shared with all interested parties? | | | | |
| | | | | | | |

| | Key Action Item | Yes | No | Done by or N/A | Comments |
|---|---|---|---|---|---|
| f. | Has a contingency plan been considered to outline alternative courses of action if the intended succession cannot occur? | | | | |
| g. | Have dates been established to review, evaluate and adjust the plan annually? | | | | |
| 15 | **Consulting outside advisors:** | | | | |
| a. | Determine need for life insurance on the owner. | | | | |
| b. | Determine the tax consequences of the succession plan and other alternatives. | | | | |
| c. | Have legal counsel prepare and review agreements and wills. | | | | |
| d. | Ensure that primary lender is comfortable with transition plan. | | | | |
| e. | Determine if an intermediary can bring open communication in cases of family conflicts. | | | | |

Checklist completed by: ______________________

Date: ______________________

EXHIBIT 2




**Steps to be completed:**

- Establish new LLC
- Establish Management Company
- Draft Intentionally Defective Grantor Trust (IDGT)
- Draft Self-Canceling installment note
- Update wills of Dad and Mom to reflect the cancellation of debt as inheritance and not gift.
- Update valuations of holdings
- Draft Lease Agreement between Management Company and New LLC
- Draft Management Services Agreement
- Draft Consulting Services Agreement
- Draft Executive Services Agreement
- Document all transactions regarding separation of Goodwill into components for ownership interests.