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**Splitting Up a Family Business:
Estate and Gift Tax Considerations-
Business Succession Planning**

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I. Introduction

Few family businesses successfully transition from one generation to the next and even fewer stay in a family for 3 or more generations. Is it because the business fails? Not necessarily. Business failure is always a possibility, but what about successful businesses? Why is the succession rate so low?

The answer may be poor planning. Business succession arrangements require a mastery of numerous legal and tax complexities, the science of the subject. These are important, but few plans fail because of the technicalities. More are ineffective because they fail to incorporate the human context of the family or the business organization.

Unlike the legal and tax context, which tend to be similar for each fact pattern, the human issues are unique to every family and business. Understanding and incorporating the human dimension requires different skills in a lawyer, skills that are more artistic than scientific.

No matter how technically correct, no business succession plan can accomplish its objectives if the various stakeholders of the business are not treated equitably. The stakeholders include the family, non-family owners, and employees.

The estate tax makes matters even more difficult because if a business owner does no planning, ultimately the IRS is a substantial “partner” in the business. This partner demands liquidity nine months after death, making it harder to carry on the business or divide the business among family members.

This Outline will consider the tax and non-tax aspects of business succession planning.¹ The beginning point of any successful plan must be a clear understanding of the value of the business and the sensitivity of the value to intrinsic characteristics of the business and outside influences.

If a business has owners other than family members, a realistic appreciation of value is critical to ensure that the decedent’s family receives fair value for its interest in the business without jeopardizing the future of the enterprise. In a business owned entirely by one family, it is often the case that the business will pass to family members active in the business with other assets passing to other family members. Again, understanding value is essential to a fair allocation of family wealth.

This Outline first covers valuation principles for transfer tax purposes and how these principles relate to buy-sell arrangements. It then discusses ten strategies that should be consider in any business succession plan. Finally, the Outline provides a checklist of wealth succession techniques often used to reduce transfer taxes.

¹ In this Outline the phrase business succession plan includes two types of arrangements. One is a buy-sell agreement, which is commonly used by unrelated owners of a business to provide for the succession of ownership in the event of certain events such as death or disability. The other type of arrangement is a wealth succession plan designed to allocate wealth, including a family business, among family members.

All section references herein are to the Internal Revenue Code of 1986, as amended (the “Code”) and to the regulations issued thereunder (the “Regulations”).

II. Transfer Tax Valuation Principles²

- A. Willing Buyer Willing Seller Test .** The most fundamental valuation principle for transfer tax purposes is the willing buyer willing seller test. The Regulations formulate the test as follows: “fair market value is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both have reasonable knowledge of relevant facts.”³
- B. Valuation of Stock .** The application of the willing buyer willing seller test is usually straightforward in the context of publicly traded securities. We look to the mean between the highest and lowest quoted selling prices on the valuation date.⁴ With non-publicly traded stock the valuation process is much more complex. The Code provides that the value of stock of a non-publicly traded corporation shall be “determined by taking into consideration, in addition to other factors, the value of the stock or securities of corporations engaged in the same or a similar line of business which are listed on an exchange.”⁵ The Regulations attempt to identify some of the “other factors,” such as the company’s net worth, prospective earning power, dividend-paying capacity, good will, industry outlook, competitive position, management, and other factors.⁶
- C. Rev. Rul. 59-60 .** Although issued more than 40 years ago, Rev. Rul. 59-60⁷ remains the most important guidance on the valuation of privately held business interests. It is the road map for any credible valuation analysis. The IRS has modified Rev. Rul. 59-60 on several occasions, but the fundamental valuation principles articulated therein have withstood the test of time.⁸ In Rev. Rul. 59-60, the IRS acknowledges that valuation is more art than science with the following language:

“No formula can be devised that will be generally applicable to the multitude of different valuation issues arising in estate and gift tax cases. Often, an appraiser will find wide differences of opinion as

² For a comprehensive discussion of valuation concepts, see Lavoie, 831-2nd T.M., Valuation of Corporate Stock.

³ Regs. §20.2031-1(b) and §25.2512-1.

⁴ Regs. §20.2031-2(b) and §25.2512-2(b).

⁵ §2031 (b).

⁶ Regs. §20.2031-2(f)(2) and §25.2512-2(f)(2).

⁷ Rev. Rul. 59-60, 1959-1 C.B. 237.

⁸ See Rev. Rul. 65-193, 1965-2 C.B. 370 (relating to intangible assets); Rev. Rul. 77-287, 1977-2 C. B.319 (relating to stock subject to SEC restrictions); Rev. Rul. 80-214, 1980-2 C.B. 101 (relating to “paired share” arrangements); and Rev. Rul. 83-120, 1983-2 C.B. 170 (valuation of preferred stock).

to the fair market value of a particular stock. In resolving such differences, he should maintain a reasonable attitude in recognition of the fact that valuation is not an exact science. A sound valuation will be based upon all the relevant facts, but the elements of common sense, informed judgment and reasonableness must enter into the process of weighing those facts and determining their aggregate significance.”⁹

D. Valuation Factors . Rev. Rul. 59-60 lists eight nonexclusive factors that are fundamental to each valuation case.¹⁰ They are as follows:

1. The nature of the business and the history of the enterprise from its inception.
2. The economic outlook in general and the condition and outlook of the specific industry in particular.
3. The book value of the stock and the financial condition of the business.
4. The earnings capacity of the company.
5. The dividend-paying capacity.
6. Whether or not the enterprise has goodwill or other intangible value.
7. Sales of the stock and the size of the block of stock to be valued.
8. The market price of stocks of corporations engaged in the same or a similar line of business having their stocks actively traded in a free and open market, either on an exchange or over-the-counter.

III. Common Valuation Methodologies

A. Net Asset Method . Rev. Rul. 59-60 refers to book value. The terms “book value” and “net book value” are accounting conventions. The net book value of a company is the historical cost of all of the company’s assets less its recorded liabilities. The book value approach to valuation is better understood as the “underlying asset” approach. This method estimates the value of a business by netting the value of the assets by the liabilities to determine the net asset value of the business. This requires an analysis of each asset and liability of the business to determine if a restatement is necessary from historical balance sheet treatment.

With an operating company seldom does this approach generate an accurate value for the business because it fails to take into account the goodwill associated with the business. With operating companies book value is typically viewed as a floor for valuation purposes, perhaps appropriate for companies in financial distress where liquidation is likely.

⁹ Rev. Rul. 59-60 at §3.01.

¹⁰ Id. §4.01.

The book value method is many times used in the valuation of holding companies, which have little goodwill at the holding company level.

- B. Market Value Method .** With the market value method, the subject company's value is based upon the value of similar companies that are publicly traded or recently acquired in private transactions for which information is available. To apply this approach, comparable company values are measured based upon stock prices or transactions. This value is then divided by an earning parameter such as sales, net income, or earnings before interest, taxes, depreciation, and amortization ("EBITDA"), or a balance sheet parameter such as stockholders' equity. The resulting multiple is applied to the subject company to estimate its value.

This method is ideal when a sufficient number of publicly traded or recently purchased companies that are comparable to the subject company can be identified. This is quite difficult, however. Similarity in size, methods of operation, markets and customers, accounting methods, and sales and earnings growth is important for an accurate result under this method. The more unique the subject company, the less appropriate this method of valuation.

- C. Earnings Method .** The earnings method estimates fair market value based on the earnings and cash flow capacity of a company. This approach evaluates the present worth of the future economic benefits that accrue to the investors in the business. It can be approach by two methods. If a business has a history of consistent earnings, and it is anticipated that the earnings will continue into the future, the appraiser may utilize the capitalization of earnings method. With this method a normalized level of earnings is multiplied by a capitalization factor. The capitalization factor is typically the inverse of the weighted average cost of capital ("WACC").

The WACC is the rate of return required by the providers of capital to the business in the form of debt and equity. For example, the WACC may be computed as the sum of a risk-free rate of return (such as a Treasury bond), an additional equity rate of return based on published studies (such as Ibbotson), a small company premium, and company specific risk premiums. If a company has a WACC of 20%, the capitalization rate would be 5 (1/.20). Thus, the normalized earnings would be multiplied by 5 in arriving at the value of the business.

Another commonly used earnings approach is the discounted cash flow method. It projects the future cash flows from the operations of the business and discounts them to present value using an appropriate discount rate, typically the WACC. This approach is used when the past earnings stream of a business is not representative of future prospects.

D. Valuation Adjustments . Valuing an interest in a business is typically a two step process. First, the entire value of the enterprise is established, and then the value of the interest is determined. The valuation methodologies discussed above are intended to estimate the value of the entire enterprise being valued. When valuing an interest in the enterprise it is appropriate to consider whether discounts or premiums should be applied to the interest because seldom does the value of a business interest merely reflect its proportionate share of the enterprise value. The most common adjustments include the minority interest discount and the discount for lack of marketability. The value of a controlling interest is often increased by a control premium. Valuation advisors have a number of methods of computing these discounts and the control premium. These adjustments are well recognized by the courts.¹¹

Other discounts may be appropriate as well. These include a key employee discount, a non-voting stock discount, a blockage discount, and discount for unrealized capital gains. In some instances, however, some of these discounts are considered in the determination of enterprise value in computing the WACC or other discount or capitalization multiple. It would not be appropriate to reapply the discount in adjusting the value of a particular interest in the enterprise.

E. Restrictive Agreements . Rev. Rul. 59-60 discusses the effect of options and buy-sell arrangements on the determination of value.¹² It concludes that restrictive agreements are merely one factor to be considered with other relevant factors in determining fair market value. Restrictive agreements and the circumstances under which they are determinative of value are discussed in IV below.

IV. Buy-Sell Arrangements¹³

A. Determination of Price.

1. Formula. Using a formula to determine the price at which an interest in a business will be purchased or redeemed is common in buy-sell arrangements. Typically, the formula will be based on asset value or earnings with an appropriate multiple applied--for instance, 3 times net asset value or 5 times some measure of earnings or cash flow.

Whether to base the formula on asset value or earnings is generally dependent upon the industry in which the business operates. The appropriate methodology for the industry tends to remain constant. The multiple, however, varies significantly depending upon factors

¹¹ For a listing of cases and the respective discount or premium, see Worksheet 2 of Lavoie, *supra*.

¹² Rev. Rul. 59-60 at § 8.

¹³ For a discussion of buy-sell arrangements and estate planning for owners of privately held businesses, see Mezzullo, 809-2nd T.M., *Estate Planning for Owners of Closely Held Business Interests*. See also Akers and Sildon, *A Practical Guide to Buy-Sell Agreements* (2002).

intrinsic to the business or the general business cycle. Just as the price/earnings ratios of publicly traded securities vary significantly over time, the valuation multiples of privately held companies are anything but constant. Therein lies the challenge in finding an appropriate formula to determine the purchase price in a buy-sell arrangement. To the extent the business is sufficiently similar to publicly traded companies, the buy-sell formula could rely upon the appropriate multiples of the guideline companies. This provides for a more dynamic valuation methodology that remains a fair measure of value as long as the business remains similar to the guideline companies over time.

2. **Agreed Value.** Many business owners rely on an agreed value to determine the purchase price for buy-sell purposes. The agreement contains a certificate of value that is updated periodically. The benefit of this approach is certainty, which is particularly important when the owners are relying upon insurance proceeds to fund the purchase or redemption.

Provided the certificate of value is revised on a regular basis in an arm's length manner, the agreed value approach is perhaps the best at assuring a fair purchase price with no surprises. If, however, the certificate of value is not updated regularly, or the relative bargaining power of the owners is not equal, the agreed value approach can create a very inequitable result. When using an agreed value approach, the agreement should provide that if the certificate of value is not updated within a reasonable time prior to the triggering event, some other method is used to determine price.

3. **Appraisal Procedure.** Provided the appraisal procedure does not favor one party over another, this method will generally prove to be the most fair for all interested parties. Most business owners would use this method to determine price if it were not for the expense of the process and the uncertainty of the result. Because business appraisals require judgment calls, no two valuation experts will reach the same conclusion in valuing a business interest. Any appraisal procedure needs to acknowledge this by providing for multiple appraisals to the extent the initial appraisal or appraisals are unsatisfactory to interested parties.
4. **Fair Market Value or Fair Value?** A buy-sell agreement or other business succession plan must be clear on whether a business interest will be valued at fair market value or fair value. Fair market value tends to be a tax concept that is derived from the willing buyer willing seller test set out in the Regulations. In arriving at the fair market value of a business interest, it is typically appropriate to adjust the value based on discounts or premiums. Fair value is a state law concept that is found in many state corporate statutes and case law. Fair value is not necessarily

based on the willing buyer willing seller test. As its name implies, fair value is an equitable concept aimed at achieving a fair result for a shareholder whose interest in the enterprise is being cashed out perhaps involuntarily—in other words, not a willing seller.

Typically, fair value is the appropriate method for buy-sell purposes because the selling party is disposing of the business interest after a trigger event that is beyond his or her control—death or disability. Thus, the seller is not a willing seller. Applying discounts produces a windfall for the continuing business owners. In the family business context using discounts and premiums to value the business for wealth allocation purposes, will result in inequitable results if it is contemplated that the business will continue in the family. Members of the younger generations are not necessarily willing buyers or willing sellers.

5. **Contingent Payments.** It is not uncommon for a business to engage in a sale or merger after an event triggered under a buy-sell arrangement. The subsequent transaction could be based on a value that is significantly different from the value used for buy-sell purposes. This creates an inequitable result for the party whose interest was retired under the buy-sell arrangement. It is not uncommon for buy-sell agreements to provide that in the event of a transaction involving the company within a certain period of time after the triggering event, additional consideration will be paid to the owner whose interest was retired or his heirs or personal representative. The time period and the amount of additional consideration are subject to negotiation.

B. Effect on Value for Transfer Tax Purposes.

Buy-sell arrangements and other restrictive agreements under certain circumstances can fix the value of a business interest for gift and estate tax purposes. The rules differ depending upon whether the agreement was entered into before October 9, 1990, and not substantially modified thereafter¹⁴ (the “traditional rules”), or after October 8, 1990, the effective date for the additional requirements of Section 2703 (the “new rules”).

1. **The Traditional Rules.** The Regulations set forth three requirements that must be satisfied for a buy-sell arrangement to fix value for transfer tax purposes.¹⁵
 - a. The agreement is binding upon the decedent during his or her lifetime and at death;¹⁶

¹⁴ See Regs. § 25.2703-1(c) for what constitutes a substantial modification.

¹⁵ Regs. § 20.2031-2(h).

¹⁶ For cases interpreting this requirement see *Matthews Est. v. Comr.*, 3 T.C. 525 (1944), acq. 1944 C. B. 19; *Giannini Est. v. Comr.*, 148 F. 2d 285 (9th Cir. 1945), cert. denied, 326 U.S. 730 (1945); *Weil Est. v. Comr.*, 22 T.C. 1267 (1954), acq. 1955-2 C.B. 10; *Comr. v. Bense*, 100 F.2d 639 (3rd Cir. 1938); *Seltzer*

- b. The agreement is a “bona fide business arrangement;”¹⁷ and
 - c. The agreement is not a device to pass the business interest to the natural objects of the decedent’s bounty for less than adequate and full consideration in money or money’s worth.¹⁸
2. **The New Rules.** Section 2703 was added to the Code, along with the other provisions of Chapter 14, by the Revenue Reconciliation Act of 1990. In general, Section 2703 provides that a buy-sell agreement will not fix the value of a decedent’s interest in a business unless the following requirements are satisfied.¹⁹
- a. The agreement is a bona fide business arrangement,²⁰
 - b. The agreement is not a device to transfer the business interest to members of the decedent’s family for less than full and adequate consideration in money or money’s worth;²¹ and
 - c. The terms of the agreement are comparable to similar arrangements entered into by persons in an arms’ length transaction.²²
3. **Regulatory Safe Harbor.** The Regulations provide a safe harbor for certain rights and restrictions.²³ An arrangement is deemed to meet all three of the new requirements if more than 50 percent by

Est. v. Comr., 50 T.C.M. 1250 (1985); Littick Est. v. Comr., 31 T.C. 181 T.C. 181 (1958), acq., 1959-2 C.B. 5; Obering Est. v. Comr, 48 T.C.M. 733 (1984).

¹⁷ Maintaining control of a business within a group, including a family group, has been held to be a valid business arrangement. See Bischoff Est. v. Comr., 69 T.C. 32 (1977); N.L. Roth v. U.S., 511 F. Supp. 653 (D. Mo. 1981), rev’d on other grounds, St. Louis Co. Bank v. U.S., 674 F.2d 1207 (8th Cir. 1982); Reynolds Est. v. Comr., 55 T.C. 172 (1970); Hall Est. v. Comr., 92 T.C. 312 (1989).

¹⁸ For cases interpreting this requirement see St. Louis Co. Bank, supra; Lauder Est. v. Comr., T.C. Memo 1990-530; Gloeckner Est. v. Comr., 152 F.3d 208 (2d Cir. 1998). A valid business purpose does not necessarily mean that the arrangement is not a device.

¹⁹ Section 2703(b).

²⁰ The legislative history to Section 2703 rejects any prior case law that would suggest that the maintenance of family control is a sufficient purpose to negate characterization as a device. 136 Cong. Rec. § 15683 (1990). The Regulations also make it clear that each test is separate and demonstrating a bona fide business purpose is not sufficient to establish that the restriction is not a device. Regs. § 25.2703-1(b)(2).

²¹ The Regulations substitute the language “natural objects of the transferor’s bounty” for the language “members of the decedent’s family.” Regs. § 25.2703-1(b)(1)(ii).

²² This is a departure from the traditional rules. Regs. § 25.2703-1(b)(4) provides: “A right or restriction is treated as comparable to similar arrangements entered into by persons in an arm’s length transaction if the right or restriction is one that could have been obtained in a fair bargain among unrelated parties in the same business dealing with each other at arms’ length. A right or restriction is considered a fair bargain among unrelated parties in the same business if it conforms with the general practice of unrelated parties under negotiated agreements in the same business. This determination generally will entail consideration of such factors as the expected term of the agreement, the current fair market value of the property, anticipated changes in the value of the property during the term of the arrangement, and the adequacy of any consideration given in exchange for the rights granted.”

²³ Regs. § 25.2703-1(b)(3).

value of the property subject to the right or restriction is owned by individuals who are not members of the transferor's family.²⁴ To satisfy this safe harbor the property owned by these individuals must be subject to the right or restriction to the same extent as the property owned by the transferor. Because of the expansive definition of family for purposes of this safe harbor, it is unlikely to apply in the family business context, even for family businesses that are owned by multiple branches of a family.

4. **Estate of True and Estate of Blount.** Included in these materials is an Outline by Stephanie B. Casteel entitled *Buy-Sell Agreements Under Section 2703 After True and Blount*. Stevie's Outline contains a thorough discussion of Section 2703 and the True and Blount cases.

V. **Business Succession Planning**²⁵

- A. **The Dilemma—What is Fair ?** Whether a successful family business is a blessing or a curse for a family depends upon the decisions made by the older generation in the succession plan and how well those decisions are communicated to the younger generations. Many times it is easy because retention of the business is not realistic, perhaps because there is no management succession plan. If the business is sold, the proceeds can be divided with other assets of the estate, and the business does present any difficult issues of fairness among the children. Similarly, where a business is managed by professional managers who are not family members, the business interest can be viewed as "just another asset" and distributed along with other assets of the estate.

The problem arises when children or grandchildren are active in the business. It is seldom the case that family members make equal contributions to the success of the business because of differences in ability or inclination. Resentment over these differences surfaces quickly after the death of the patriarch or matriarch. It is sometimes the case that children are blind to the shortcomings of their siblings or willing to overlook them for the sake of family harmony. It is just as often the case that the children's spouses are very aware and less willing to look the other way.

A business owner must be realistic about this dynamic and deal with the issues presented. Typically, this will mean that the business goes to family members who are interested in running it. Assets other than the

²⁴ The transferor's family is determined under Regs. § 25.2701-2(b)(5) for this purpose. Family includes the transferor, any lineal descendants of the parents of the transferor or the transferor's spouse, and applicable family members, which include the transferor's spouse, ancestors of the transferor and the transferor's spouse, and the spouses of such ancestors. In addition, family includes "any other individual who is a natural object of the transferor's bounty." See Regs. § 25.2703-1(b)(3).

²⁵ For an overview of business succession planning issues see Koren, 31. U. Miami Inst. On Estate Plan. (1997) and Le Van, *The Survival Guide For Business Families* (1999).

business go to other family members. Determining the value of the business for these purposes is critical. To the extent family members are active in the business, careful consideration must be given to the value created by their contribution of time and energy. It is seldom the case that the parent, the child active in the business, and other children have an even similar view of the active child's contribution to the business. Achieving fairness or, perhaps more importantly, a perception of fairness for family members is critical.

The success of the business succession plan is also important for non-related owners of the business and employees of the business. A poor plan can impact all of the stakeholders of a business to the extent it fails to adequately recognize the contribution of non-family members and their ongoing roles. Moreover, a poor plan can result in an ownership structure where control is uncertain or so fragmented that no single group has sufficient economic incentive to care whether the business survives. These issues must be addressed in the interest of fairness to all interested parties of the business.

B. Business Succession Planning Checklist

- 1. Obtain a Professional Valuation.** The starting point for a successful business succession plan is a valuation analysis prepared by a qualified and objective valuation expert. Few business owners have a realistic understanding of the value of their businesses. The valuation process provides an educational opportunity for the business owner to look at the business from a more objective perspective, perhaps the way it will be viewed by his family or the IRS after his or her death. No fair succession plan can begin without an understanding of the value of the business and the factors that impact its value. As mentioned earlier,²⁶ it is important to consider whether the business should be valued at fair market value or fair value and any plan should be clear on which method will apply.
- 2. Expand the Professional Team.** Although many attorneys, CPAs, and CLUs have expertise and experience in business succession matters, resolution of certain issues may require other disciplines. There are professionals who approach business succession from perspectives other than legal or tax. These individuals are trained in management, psychology, organizational dynamics, or cultural anthropology. They have the skills to unearth the business and family culture that provides the context for the plan. The business owner is too close to the action to understand the dynamics at play.

²⁶ See IV A. 4 supra.

- 3. Expand the Business Team.** Many privately held companies have little or no depth in the management ranks. This is a mistake for two reasons. First, from a valuation perspective a business has a greater value to the extent it has management depth. Second, the likelihood of a successful succession plan will be enhanced to the extent management authority succeeds to managers with a history in the business.

The boards of directors of many private companies fail to include outside directors. This is a mistake because the board of directors will have significant responsibilities after the death of the business owner. The experience of outside directors can be invaluable during this time of loss for the family. Outside directors are particularly reassuring to the employees of the business, who many times are concerned by the absence of authority.

Because individuals assume fiduciary duties by serving on boards of directors, some companies invite outsiders to serve on a board of advisors. The board of advisors meets periodically to review the operations of the business. The board of advisors is a part of the succession plan that is visible to the family and the employees. When necessary the board of advisors could assume the role of the board of directors or could serve an advisory role to the family or new management recruited after the death of the business owner.

- 4. Enter into Employment Agreements with Key Employees.**

The retention of key employees is critical to a successful business succession plan. Key employees should have the security of knowing that the death of a business owner will not jeopardize their employment. Likewise, the business needs the assurance that its key employees will not abandon the company shortly after the death of a business owner. Employment agreements containing an employment term after the death of the owner can give key employees the comfort they need.

Employment agreements can provide incentives for key employees to stay on after the death of an owner by providing for additional compensation to employees that complete a transition term. This is like a “retention bonus” that many financially troubled companies offer to key management to keep talent from seeking greener pastures.

The role of key employees should be defined in the succession plan. This is important for several reasons. Key employees of family businesses often feel threatened by family members who may have management ambitions. Many children of business owners are anxious to prove that they are as capable as the older generation in running the business. Often times, these ambitions are unrealistic, and everyone is aware except the child who does

not know what he or she does not know. Judgments about management succession must be made by the older generation or by the board of directors or board of advisors.

To protect them from ambitious family members, management may need protection from termination “without cause.” Similarly, protection from irrelevance may be appropriate. This is achieved by compensating the executive if he or she resigns for “good reason.” Good reason may include change in title, curtailment of responsibilities, or reduction in compensation or benefits.

5. Design a Fair Compensation System. A fair compensation system is critical to the success of any business. During the life of the patriarch or matriarch it is common for the system to operate as a benevolent dictatorship with employees trusting the judgment of the decision maker. Any successful business succession plan must address the fact that after the death of the key owner a new arrangement must be put into place. The issues are numerous. Who will determine compensation—the board, management, or the owners? What compensation arrangements are best designed to fulfill the goals of the business—salary, bonus, deferred compensation? Is equity based compensation, such as options or restricted stock, appropriate or is it critical to keep ownership in the family? If so, would a phantom stock arrangement satisfy management’s expectation of ownership? Is an ESOP appropriate? To the extent one family member or group has voting control of the business, what limits on compensation are necessary to avoid abuse of the compensation system?

6. Obtain Adequate Life Insurance on Owners and Key Employees. Life insurance is an important component of most business succession plans. In a buy-sell arrangement it provides a means to prefund all or a portion of the purchase price paid to the heirs of the deceased owner. This allows the heirs to realize a fair value without placing a burden on the continuing owners. When the goal is to perpetuate the business within the family, life insurance is critical to provide the liquidity to pay estate taxes. Here it is common for the insurance to be owned by a party other than the insured, such as a life insurance trust or partnership owned by younger generations.

Finally, insurance may be necessary to augment an estate to the extent the business is passing to some family members but not others. If the estate is not large enough to achieve equality, life insurance can make up the difference, providing assets to family members who will not receive an interest in the business. Conversely, to the extent liquid assets will pass to inactive family members, insurance can provide liquidity for family members receiving the business.

Key person life insurance may be appropriate as well. This is insurance payable to the business to compensate for the loss of the leadership and management skills of the deceased owner. The proceeds may be necessary to provide financial stability to recruit or retain talented management.

7. **Analyze the Capital Structure.** In many business succession plans one size does not fit all. In other words, different owners need an equity ownership piece that is different from other owners. Some owners may have a need for income and are less concerned about capital appreciation. Preferred stock or a preferred partnership or membership interest can accommodate these divergent goals. A preferred interest can be designed to accomplish various financial goals depending on the circumstances. Although an S corporation can have voting and nonvoting stock, it cannot have preferred stock. Consequently, S corporations provide little flexibility in designing a capital structure that provides different financial rights for owners.

Many business owners choose to segregate certain assets, such as real estate or intellectual property, from the operating assets of the business. Generally, this is done for tax or liability reasons. Gain is triggered distributing appreciated assets from a corporation, even an S corporation. In general, this is not the case with a partnership or limited liability company. A separate entity also can serve to insulate the real estate or intellectual property from the claims of creditors of the operating business. The asset holding company leases the real estate or licenses the intellectual property to the operating company in consideration for rents or royalties. This type of ownership structure allows a business owner to separate the assets for estate planning purposes. Business assets are converted to investment assets that can pass the family members not active in the business.

8. **Appropriately Allocate Voting Control.** Allocation of control is a common issue for parents in dividing the family business. The challenge is to give those active in the business the authority necessary to fulfill their responsibilities without enough power to abuse their position. As a general rule owners who are active in the business should have control. A capital structure that includes voting and nonvoting interests will allow those active in the business to control it without regard to the percentage of the overall value they own. A similar result can be achieved with a limited partnership or limited liability company because the general partner or manager controls regardless of ownership percentage.

Care must be exercised, however, in protecting the non-controlling owners. Minority or otherwise non-controlling owners may need

rights that give them input into compensation, dividends or distributions, operating and capital expenditure budgets, major transactions, transactions with affiliates, hiring and firing, and other significant business matters. In the alternative, non-controlling owners could be given an exit alternative to the extent they are dissatisfied with the decisions of the controlling owners. This could include a put right that requires the redemption of their ownership interest. This put right could be tied to some level of performance by management below which the non-controlling owners have the right to cash out. If this is too harsh of a result, the ownership could be structured in such a manner that control shifts if certain performance criteria are not achieved.

9. **Communicate the Plan.** After the death of the matriarch or patriarch, a new social order emerges within a family. When families are connected economically through a family business, the dynamics are more complex because the stakes can be high. Family members will have divergent views on the future of the business, each certain that their plan is what the parent would have wanted. Business owners must clearly communicate the succession plan with family, non-family owners, key employees, and the board of directors or advisors. The key elements of the plan should be documented in writing.

The plan should cover management succession, control, compensation issues, and valuation. To the extent the business is passing to family members active in the business with other assets passing to others, the parent should explain his or her reasons for the division especially if those active in the business are receiving credit in the valuation for their efforts.

10. **Consider Wealth Succession Strategies to Reduce Transfer Taxes.** Any business succession plan will benefit from estate planning strategies that have the effect of reducing estate taxes. This has the effect of preserving wealth, which increases the chances of a successful transition of the business. These techniques include among others discount entities, gifts, grantor retained annuity trusts, installment sales to intentionally defective trusts, preferred stock recapitalizations, freeze partnerships, charitable lead trusts, and “opportunity transfers.” An opportunity transfer is the process of structuring the ownership of a business opportunity in such a manner that the older generation owns a small, perhaps preferred or controlling interest, and younger generations own the balance of the enterprise. This all occurs before the opportunity has generated material value. Many times an opportunity transfer involves the older generation serving as a lender to an entity owned by younger generations. The older

generation receives a creditors return on its capital while the younger generations enjoy the balance of the wealth creation.

VI. Wealth Succession--Checklist of Techniques

A. Discount Strategies

1. Fractionalization of voting control
2. Family limited partnership or limited liability company
3. Buy-sell arrangements

B. Freeze strategies

1. Opportunity transfers
2. Gifts
3. Grantor retained annuity trusts
4. Installment sales
5. Freeze partnerships
6. Charitable lead annuity trusts