

Insights

Three Minute Update - Day in the Life of a Business: Will Your Business Continue to Thrive If You Do Not Survive?

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Running a family business can be all-consuming, but it is vital for owners to take time to develop and implement a succession plan for death, retirement, or incapacity. Failing to plan for ownership change could affect the long-term survival of the business and the preservation of wealth built by the business. A proper business succession plan can drive the growth of the business, reduce taxes, and even allow the owner to enjoy retirement.

The Basics

One important component of a succession plan should be a buy-sell agreement, addressing what happens to ownership interests in a business upon death, disability, retirement, or planned exit of the owners. These agreements will be needed whether the entity is a corporation or an LLC.

The buy-sell agreement will be between the business and the owner or owners, if more than one. The agreement will also impact "key persons" (important employees of the business), family members, or outside individuals, or combinations of all of the above. A buy-sell agreement can also create a guaranteed market for the business interest in the event of the owner's death, disability, retirement, or planned exit and prevent all or part of the business from falling into the hands of "outsiders" (i.e., those outside the family and, if applicable, key insiders).

When implementing a buy-sell agreement, an owner should also consider the funding of the financial obligations created by the agreement. Oftentimes, funding is done through life insurance. A life insurance partnership can be created to hold life insurance policies on the owners or partners, enabling multiple owners/partners to buy out the deceased shareholder's or owner's interest.

Further, "key person" insurance can be purchased by the business on the life of an owner, a top executive, or another individual considered critical to running the business. The company can be the beneficiary of the policy and will usually pay the premiums. Essentially, "key person" insurance offers a financial safety net if the sudden loss of a certain individual would profoundly and negatively affect the operations of the business. The death benefit from the insurance policy essentially buys the business time to find a new person to replace the decedent or to implement other strategies to save (or shut down) the business.

Finally, a business succession plan is only effective if it is communicated to key employees or family members. An owner should be proactive and have open and frequent conversations about the succession plan with key employees and family members as well as his or her team of advisors (financial advisor, life insurance agent, accountant, business attorney and estate planning attorney). In the event of an ownership change, the plan can be implemented quickly, and the business can continue. An owner might even consider a “trial run” of the succession plan, where certain key employees or family members take on more responsibility while the owner or manager is away. This allows the owner to assess what additional professional development and training might be necessary while providing key employees valuable experience and “ownership mentality.”

An additional way to attract and retain key employees is through employee retirement plans or deferred compensation agreements. Moreover, an “employee stock ownership plan” or ESOP plan is a stock bonus plan where a business can place its stock in a trust, which may qualify as a tax-exempt employee trust. Employees are then allocated shares proportional to their annual compensation, but if they leave, the stock is sold back to the business. Under this alternative, the owner can essentially shift his or her investment, usually on a tax-deferred basis, into publicly-traded securities. By doing so, the owner essentially creates a market for his or her stock and provides a way to motivate and compensate his key employees.

Wealth Transfer Planning

Separation of ownership from control is a key first step for transferring wealth created by a business. One of the most common planning techniques fractionalizes the ownership structure of the business into voting and non-voting shares or units. Those non-voting shares or units can then be gifted or utilized in a part-gift/part-sale transaction and can be transferred to specialized trusts, like a grantor retained annuity trust (“GRAT”), spousal lifetime access trust (“SLAT”), or an intentionally defective grantor trust (“IDGT”). These specialized trusts not only receive the business interests, but any appreciation on that interest also passes outside the owner’s gross taxable estate. Moreover, non-voting shares or units may be subject to minority discounts, which can range between 10% to 40%.

Further wealth planning strategies include a simple installment sale of a business, which can spread out the taxable gain and thereby defer the income tax on the gain from the sale of the business. This is often done when an individual purchasing the business might not have enough capital to purchase the business outright, such as a younger family member. A simple installment sale also freezes the estate value of the assets sold for estate tax purposes, and no gift tax is incurred on transfer if the business is sold at fair market value.

An owner could also choose a private annuity arrangement, where the owner conveys complete ownership of a business to an individual and the individual, in turn, promises to make periodic payments to the owner for a period of time, which could be for the owner’s life, or in some cases, the owner’s life plus the life of his or her spouse. This allows the owner to retire and still receive income for a significant period of time and remove assets from his or her gross taxable estate.

In sum, there are many techniques that can be used in a business succession plan to pass the business to family members or key employees, provide liquidity to an owner’s estate or income to an owner for his or her lifetime, and/or transfer wealth out of an owner’s estate to reduce taxes. The important step is starting. If you or your business needs assistance with developing or implementing a business succession plan, please contact **Rodney S.**



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