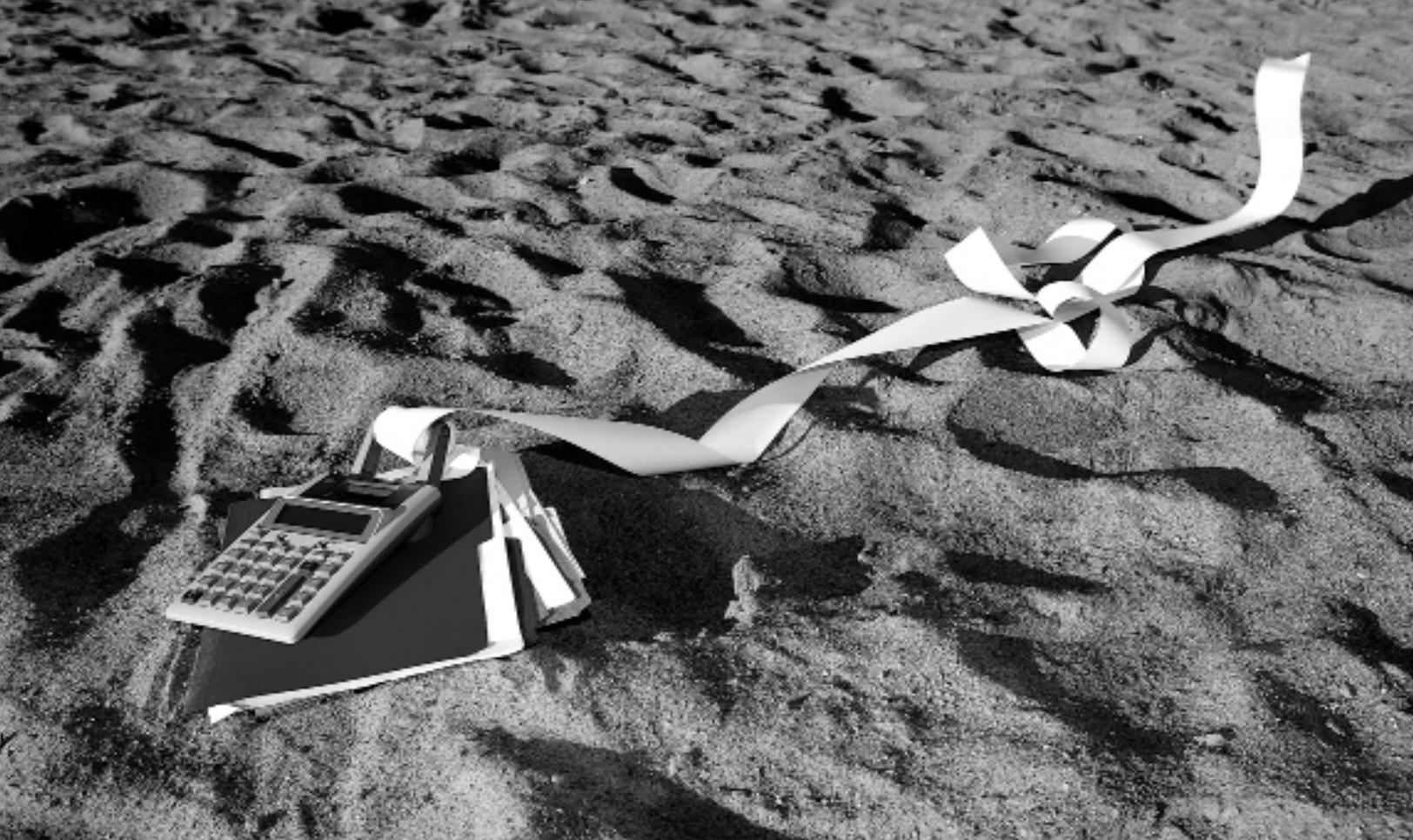




# An Owner's Guide to Business Succession Planning

2nd Edition

The Ohio Employee Ownership Center



AN OWNER'S GUIDE TO BUSINESS SUCCESSION PLANNING is a basic roadmap to assist owners of small and medium-sized business as they begin to plan for ownership and management succession. Inside you will find:

- A simple six-step process that will help business owners plan for succession. The process is designed to insure that it is the owner's goals that shape succession planning tools like insurance and trusts, not the other way around.
- An overview of the more common strategies and tools from which you may select to implement your succession plan

The book also includes resources for your own planning, suggested readings, worksheets to help you through the process, and a succession planning video on an enclosed dvd.

An Owner's Guide to

# Business Succession Planning

2nd Edition

Stephen Clifford

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The Staff of the Ohio Employee Ownership Center

Ohio Employee Ownership Center  
Kent State University  
Kent, Ohio

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Visit the OEOC's web site at <http://www.kent.edu/oeoc>.

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## Introduction

*An Owner's Guide to Business Succession Planning* is designed to assist owners of small and medium-sized businesses as they begin to plan for ownership and management succession. As such, it contains a simple six-step process that will help business owners plan for succession, and a brief summary of some alternatives available for ownership succession.

This guide has four main parts.

The first part introduces and discusses some of the issues around succession planning.

The second part outlines a six-step process that will help owners develop a cohesive set of goals for the succession planning. Matters as complex as the creation of a succession plan are seldom simple and linear. Therefore it is likely that you will not follow this process exactly. Reviewing the planning process can help the business owner check his or her progress and insure that important issues are not neglected. This part of succession planning is a goal-setting process, and your objectives should drive your technical plan for succession.

Once the important issues of goals have been discussed and explored, and the business owner has arrived at a "Best case scenario" (step 4 in the process), we recommend that the business owner seek competent professional advice. These can be found in your community through local business and professional organizations, and contact information for those who are professional members of the OEOC are listed on the OEOC website at <http://www.kent.edu/oec>. These professional advisors can help a business owner achieve the goals of the "Best case scenario."

The third part of this manual reviews some of the alternative strategies and technical choices which can be used to implement your succession plan. You will need legal advice to implement these.

The last part of this manual includes various resources which you may find useful: worksheets which can be used as you work through the process, a list of additional reading, and a review of the major provisions of recent tax law that affect succession planning.

This manual was written originally as part of the Cleveland Succession Planning Program. Our special thanks to the Cleveland and George Gund Foundations which have financially supported that program and the development of its manual, and to Neil Waxman, Managing Director of Capital Advisors, for his care in reviewing this document. We also appreciate the support of the Greater Cleveland Growth Association and its Council of Smaller Enterprises for the succession planning seminars and the Northeast Ohio Research Consortium of the Ohio Urban University Program which funded the research that preceded implementing the Cleveland Succession Planning Program.

Boston, 1999  
Kent, 1999

Stephen Clifford  
Alex Teodosio

## **Introduction to the 2nd edition**

Over the decade since the first edition of this manual was written, business ownership succession planning has increasingly come to be recognized as an important aspect of economic development, and family business has increasingly become a fashionable subject for academic study. None of this, however, has really affected the techniques of and the need for business ownership succession planning in family firms.

What has affected succession planning has been the gradual decline in the number of children in the average family and the likelihood that business owners' children will enter the professions. Average number of children per family has dropped from 3.5 in 1900 to 2.2 in 1955 to 1.8 today in 2006. The proportion of 25-29 year olds with a college degree has jumped from 10% in 1957 to 30% in 2007. While over half of business owners still want the business to stay in the family, data indicate that only 30 percent of family businesses will pass to the 2nd generation and only 15 percent to the 3rd.

This new edition has been updated for changes in the tax law and new developments in succession planning strategies, most notably to include the possibility of selling your business to your employees through an employee cooperative while getting the same capital gains tax deferral as you would using an Employee Stock Ownership Plan; this should be a particular advantage for owners of smaller businesses (up to 25 employees) who are interested in selling to their employees but might find ESOPs too expensive a method to do so.

One thing that should be noted is that tax law on business succession will change dramatically in the next few years. The estate tax rate is scheduled to drop to zero in 2010 and then jump back to a 45% rate in 2011. Few expect Congress to let that provision stand, but no one can predict the form of a new estate and gift tax law at this time.

Nonetheless, while tax law changes affect the mechanics of inter-generational transfers of businesses within families, they are not going to change the basic principles of business ownership and management succession laid out in this manual. For this reason, we have used generic examples in the book to illustrate certain situations. Updated tax law information is included in the pocket on the inside back cover of the book. Tax law updates will also be posted as necessary on our website at [www.kent.edu/oeoc/spp/currenttax.htm](http://www.kent.edu/oeoc/spp/currenttax.htm)

Thanks to Alex Teodosio for his editorial work on the 1st edition and to Bill McIntyre and Chris Cooper for their editorial work on the 2nd edition. We appreciate the support of the Ohio Department of Job and Family Services in supporting the development and publication of the 2nd edition of *An Owner's Guide to Business Succession Planning*.

Kent, 2008

John Logue

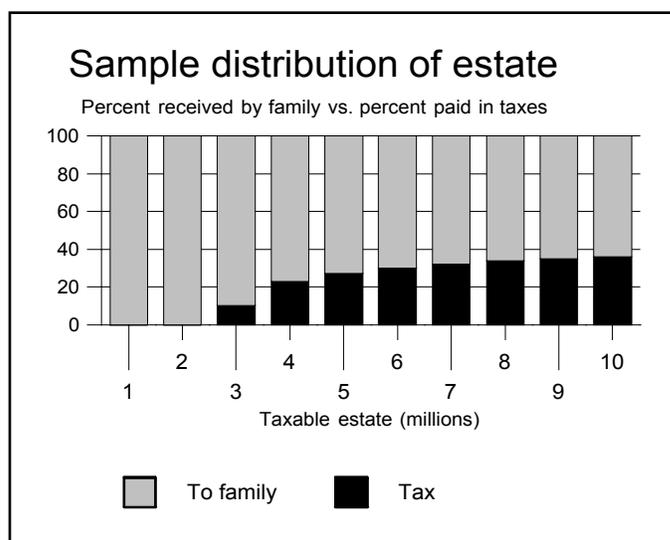
# I. Why Plan for Succession?

Running a business is hard work. Most business owners find themselves too absorbed in the business to work on the longer term problems like planning for succession. The daily work needed to make a business successful leaves no time to plan for the ownership and management changes that will inevitably occur. Moreover, when planning for succession, a number of tough personal issues surface such as “What will I do when I retire?” These issues are often more complex when there are no clear successors who can take over the business.

**On the other hand, there are five compelling reasons to plan for ownership and management succession.**

## 1) Taxes

Few business owners like to send their hard-earned money to the government in taxes. Businesses often represent the greatest life accomplishment of their owners except their families. If no plan is in place at the death of the business owner, the government takes much of the value of the business, and leaves little for his or her heirs. For example, assuming a \$2,000,000 estate tax threshold for an individual and a 45% estate tax rate, a \$1,000,000 taxable estate would incur zero estate taxes and the full \$1,000,000 would be available to the heirs after taxes; however a \$10,000,000 taxable estate will leave only 64% or \$6,400,000 to the heirs after taxes. A succession plan can reduce, and sometimes completely avoid, taxes and insure that the family and important employees get what they deserve, instead of what is left after taxes. See the addendum in the back pocket of this book for updated information on current estate tax law.

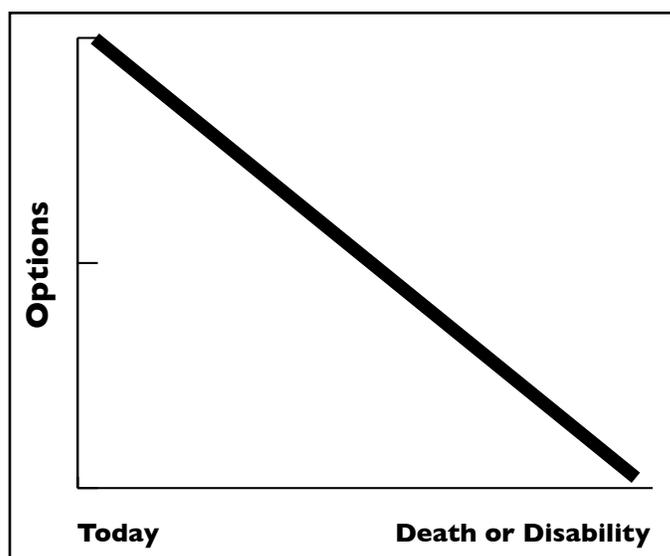


## 2) Risk

The longer owners wait to design and implement a succession plan, the greater the risk that the plan will not meet their goals. The risks also increase that the business will fail along with the health of the owner.

## 3) Options

The longer succession planning is delayed, the fewer options owners have to meet their goals. Most business owners want to provide continued income for family members and maintain jobs for family members and colleagues. They also want to establish a personal legacy through continuation of the business or a charitable contribution. The number of options available to meet these goals decrease steadily as time passes.



#### **4) Control**

By planning for succession, the business owner retains control over the outcome. When business owners fail to plan, the government or various attorneys involved will take control.

#### **5) Value**

When a business owner does not implement a succession plan before he or she is disabled or dies, the value of the business often drops rapidly. Often, the business and business owner die on the same day. This means that the owner's intended beneficiaries will not receive the full value of the business had a succession plan been in place.

**Succession planning is difficult for a number of reasons. It raises issues of inevitable life changes, of mortality, and of changes in key personal relationships.**

#### **Life changes**

- Throughout the business owner's life, an easy way to measure personal accomplishment has been the business. The success of the business is a great source of personal affirmation and encouragement. Retirement requires new measures of success.

- Our society often equates "who you are" with "what you do." As a result, business owners face an especially difficult challenge. They are used to being the top person at their business and therefore important in the community. Owning one's own business is a mark of accomplishment by itself and when owners give up that role, they often find themselves struggling with these tough question of redefining themselves.

- Business owners are used to being in control. Their opinions and ideas have added weight because they are in charge. While their advice and ideas may remain vital to the business, there is insecurity when the business owner gives up formal control.

- For years, the business has depended upon its owner and everyone likes to feel needed. While the owner's support and professional advice may still be important, a good plan prepares for a time when the former owner is not the most important leader.

#### **Mortality**

- None of us likes to think about or discuss our own mortality, but the process of succession planning is all about what will happen "when I am gone." The first recommendation of many succession planners is for the business owner to find a personal advisor to help him or her deal with the complex emotional issues involved.

#### **Relationships**

- The owner's personal identity is often intimately tied to the business. Changes in that connection often raise insecurity about the owner's personal and professional relationships. Many of these relationships change when the owner retires. Insecurity remains even when the relationship is based on personal friendship, not professional dependence.

- Often, the most significant change is in the owner's marriage. Instead of spending endless hours at the office, with an occasional break to go home, the owner will do the opposite. Retirement is about having more personal time than professional time. This changes the owner's family relationships, espe-

cially if some family members are potential successors in the business. Such changes can be extremely stressful. A failure to recognize and deal with these changes may result in failure of the family relationships.

- Relationships are challenging. The more complex a relationship becomes, the more difficult it can be to manage. When a family member becomes an employee, the relationship becomes more difficult to manage. When we add another layer of interconnectedness, the relationship often becomes even more difficult to maintain. As these relationships develop, we manage them on an incremental basis. By the time we have worked and lived together for many years, we are barely conscious of the delicate ways we have learned to keep the relationships in balance.

**For example,** a father-son relationship, often difficult by itself, becomes more complex when the son is an employee or manager at the family business. The father has become an employer and possibly a supervisor, mentor and co-owner. Each level makes the relationship more complex and difficult to manage.

When succession planning begins, it changes these relationships. The process of planning can place additional stress on these relationships as people wonder what the change will mean for them. Managers, employees, suppliers and customers all get nervous about the future. Planning for succession will shake up the delicate, complex relationships that these groups share.\*

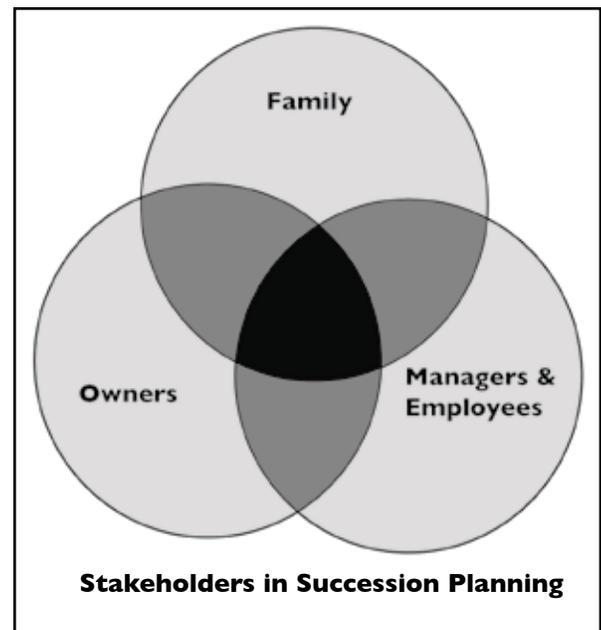
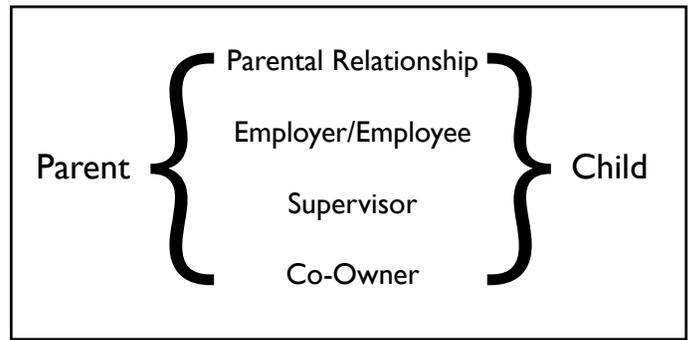
Three groups of people are most directly concerned:

- (1) Family members
- (2) Owners
- (3) Managers/employees

In small businesses, though, these groups often overlap and many businesses have people who are members of all three groups. This results in four additional categories and increased complexity in the succession planning process:

- (4) Family members who are also partial owners of the business,
- (5) Family members who are managers and/or employees, but not owners,
- (6) Owners who are also managers and/or employees, and
- (7) Family members who are partial owners and managers and/or employees.

Every member of each group is concerned about the business and the succession plan. They are likely to have hopes and expectations. If a plan is to meet any of these expectations they must first be identified. This process could raise conflicts



\* This chart and much information in this section are from Mike Cohn, *Passing The Torch: Succession, Retirement, and Estate Planning in Family Owned Businesses* (New York: McGraw-Hill, 1992). This is an excellent resource for succession planning and was used extensively in the preparation of these materials.

of interests among the people involved. A formal planning process will quell some of these conflicts as everyone can feel assured that their concerns will be heard. Despite the potential problems, the people who have a substantial stake in the outcome should be involved in the process. When they are excluded, they may build up resentment against those who are involved and reject the outcome.

Succession planning can help owners cope with these changes. A good succession plan often eases the inevitable changes faced by business owners. The life changes which business owners face are inevitable. Succession planning provides a concrete professional context in which to deal with those changes.

When business owners design succession plans, they maintain control over the outcome. If the business can remain successful through the transition, the owner has again demonstrated an enormous personal and professional accomplishment. Much like raising children, the parent's greatest pride is when the child is strong and stable on his or her own. Similarly, the continued success of the business remains a tribute to the owner's achievement. It is a legacy. When it continues to provide needed products and jobs for relatives, managers and the community, it is a touch of immortality for its creator.

It is tragic that many business owners do not plan for succession. In doing so, they deny themselves the satisfaction of knowing that they were truly successful. They deny themselves the accomplishment and pride of knowing that their lifetime of hard work established a long-term personal and professional legacy. A succession plan confronts these challenges head on.

**In summary:** A good succession plan will

- 1) meet the needs and goals of the business owner; and
- 2) meet the needs of the other important stakeholders in the business.

A good planning process will

- 1) involve all of the major stakeholders; and
- 2) retain the relationships necessary for the business to succeed and for the owner to be happy.

## 2. The Succession Planning Process: An Outline

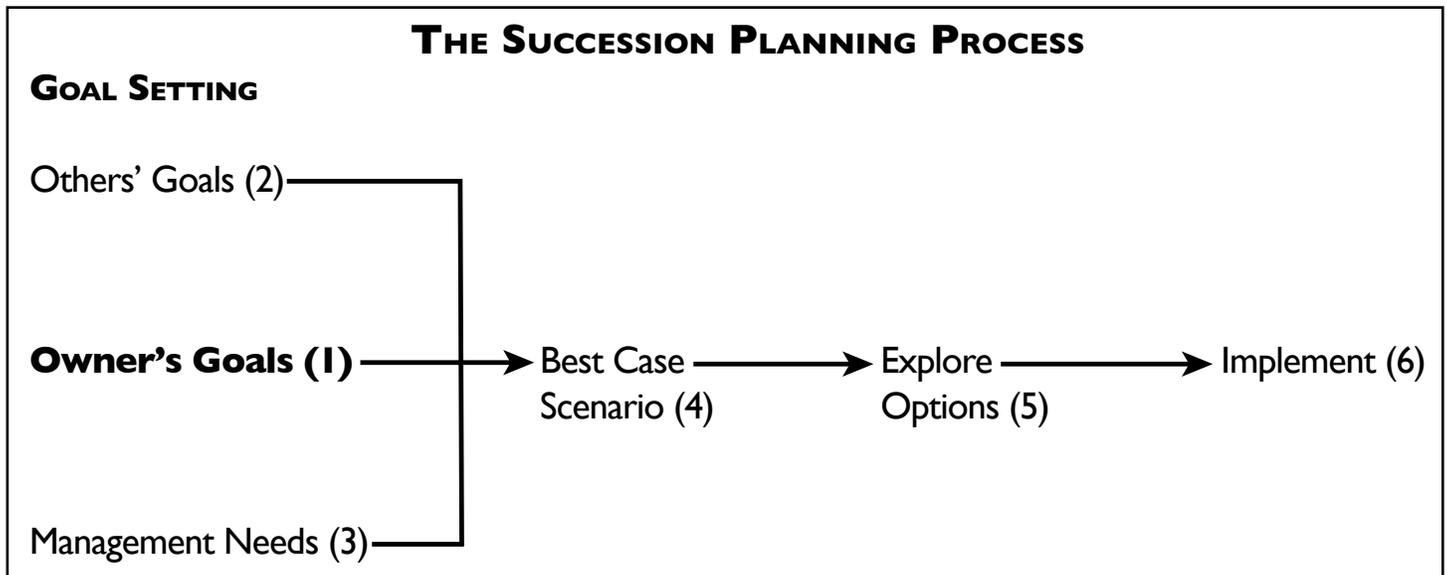
The goal is to design a plan that will meet the expectations and hopes of the business owner. Often the most important goals are to keep the business and family together. Therefore, it is critical to include these important stakeholders in the process. Sometimes when stakeholders are excluded, they do not support the outcome. Thus, an oversight in the process can cause an otherwise good plan to fail. One universal goal is to avoid anger, frustration, and litigation. In order to avoid these common problems, it is useful to have an intentional process and a time line for that process.

The succession planning process, in its simplest form, has three stages:

- (1) Identify the goals
- (2) Determine how best to meet the goals
- (3) Implement the plan

A common mistake made in succession planning is for the business owner to research or implement succession planning tools prior to identifying his or her personal goals. Often the chosen tools are inefficient or, worse, inappropriate. Identifying the goals first frequently makes the choice of tools much easier and the tools chosen are more appropriate and effective. Unfortunately, the complexity of relationships in many family businesses can make it difficult to set goals. Therefore, it is worth a careful exploration of goals at this stage. The following succession planning process is designed to help you chart your course. Extra time is spent on the first stage, since this is where many mistakes are made that can undermine the outcome.

The process can be broken into the following six steps. It can be diagrammed as follows:



Let us look in more detail at each of the steps.

1) **Identify the goals of the business owner.** Business owners should identify their personal goals for their future annual income, their level of involvement in the business, their investments both inside and outside of their business, their legacy for the future, and their values.

2) **Identify the needs and goals of the other stakeholders.** What are the needs, goals and expect-

tations of family members, other owners, and key employees? Consideration of their expectations insures that the plan will meet the goals outlined above.

3) **Management succession planning.** If continuation of the business is important, the business owner must figure out who is capable and willing take on his or her responsibilities. This process may include new compensation structures that will give key managers incentives to take on new tasks.

4) **Develop a “best case scenario.”** Based on the business owner’s values he or she must balance the needs and goals of everyone involved. The resulting plan is a “best case scenario.” This becomes the optimum situation that the business owner hopes to attain in the succession plan.

5) **Explore all options.** Explore the options available to meet the goals. This is when the abstract goals of the succession plan meet what is legal and financially feasible. The business owner needs to fully explore the options available. Unfortunately, some business owners skip these steps, and do not explore all of the options. Often, this means that after they have designed the plan, a new and more efficient solution emerges, leading to expensive changes midstream.

6) **Design and implement the succession plan.** The first stage of implementation is drawing up the legal and financial documents. The professional advisors who design the plan can also help devise a process to implement it. A time line for implementation is a way to make intentions clear while managing expectations. The time line can include specific goals or “trigger events” for managers or successors. Such goals indicate that it is time to take the next step in the plan. Of course, in order for the time line to be effective, the business owner should appropriately inform the other stakeholders. Shared information is the best way to insure implementation, avoid negative rumors and prevent destructive conflict.

**In summary:** The succession planning process is inevitably complex. A carefully designed process and time line can help everyone involved understand the process and provide benchmarks for progress. The individual steps in this six-step model are explored further in the remainder of this section. Like any model, it should be customized to fit each owner’s personal situation. The most important point is that some logical, intentional process be followed.

## Step 1: Goal Setting - The Business Owner's Goal

The first step in succession planning is to identify the goals of the business owner. The owner's goals are complex and may include concerns about other participants. However, here we are concerned exclusively with the personal goals of the business owner. Step 2 explores the interests of other interested parties.

Setting goals for the succession plan can be difficult. One reason is that the business owner wears many different hats:\*

**Shareholder:** As the main shareholder, the business owner looks to increase the liquidity of his or her main asset: stock in the business. Generally the business owner wants to turn his or her concentrated, illiquid asset into diversified liquid assets. This follows the generally accepted principal that wealth is created through concentration – and maintained by diversification.

**Employee:** As an employee of the business, the owner wants to do productive work and to contribute to business success.

**Chief Executive Officer:** As CEO, the business owner wants continued growth in the company, increased competitiveness and business success. This means a constant focus on business operations.

**Aging person:** As an aging person, the business owner wants to enjoy the fruits of his or her labor. He or she wants to enjoy life after the years of hard work in the business.

Since the goals of each “role” may conflict, it will be beneficial to look at five primary concerns of the owner. Each is explored further on the following pages.

**Income:** What are the business owner's needs and expectations for future income?

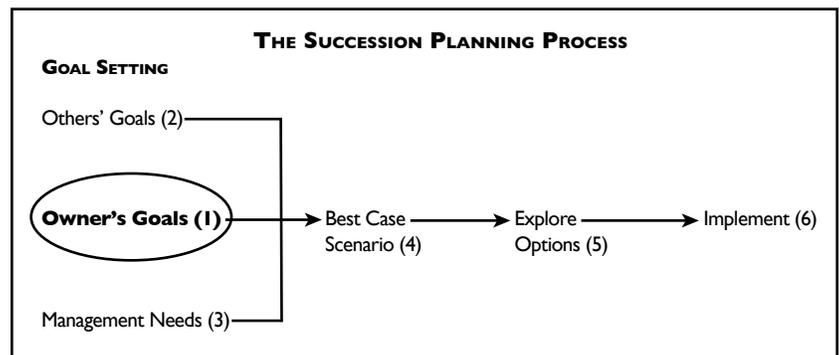
**Involvement:** What are his or her goals for future involvement in the business? Would the business owner like to remain actively involved, withdraw over a number of years, or walk away tomorrow?

**Investment:** What are the owner's goals for future investments? Does the business owner want to cash out immediately, maintain an equity investment in the business, or cash out in stages over a number of years?

**Legacy:** What are the owner's goals for a personal legacy? Does he or she want to establish a charitable trust or trusts for family members, children or grandchildren as legacies to his or her accomplishments?

**Values:** What are the values of the business owner? What is important to the owner apart from his or her personal interests? Does the business owner value the continuation of the business and continued employment for colleagues, family and employees? What about community involvement?

Each of these issues should be carefully explored in order to clarify expectations. You can write out your goals in each of these areas on Worksheet 1 at the back of this book. Unrealized expectations



\* Leon Danko, *Beyond Survival* (Cleveland: Cleveland State University Press, 1979).

often grow out of unrecognized expectations. This is the time to bring unconscious expectations into conscious focus. We will now walk through each of these concerns in detail.

### **Income**

Every good succession plan must begin with an assessment of the financial needs of the owner. The goal is to arrive at a good estimate of the income level that the owner hopes to get from the business. The expected level of income can be calculated:

$$\begin{array}{r} \text{Desired income} \\ - \quad \underline{\text{Other income sources}} \\ = \quad \text{Total income desired from the business} \end{array}$$

Let us look at each of these lines in turn. You may find it helpful to do your own calculations on Worksheets 2 and 3 at the back of this book.

**1) Desired income:** To determine the income needed in retirement, start with your current income and benefits.

A. Current compensation:

- What is the annual cash compensation of the business owner?
- What is the cost of additional benefits provided to the owner by the business?

The combination of these figures will provide a reasonable estimate of the actual value of current compensation.

B. Adjustments to expenses:

- What additional expenses can be expected when the owner enters retirement? Does he or she intend to travel more, play more golf, take on new hobbies, purchase insurance or perform maintenance on a retirement home, or purchase a new recreational vehicle?
- What expenses will go down in retirement? For example, dry cleaning, restaurant expenses, auto maintenance costs, travel costs, etc, may decline.

The current compensation and the adjustments can be combined to estimate the business owner's desired future income.

**2) Other income sources:** Are there additional sources of income that will reduce the amount needed from the business? Does the business owner have additional retirement programs, such as an IRA, 401(k), or Social Security? Are there other investments that the business owner expects to turn into cash for future income such as real estate, mutual fund investments, or investments in other businesses?

**3) Total income needed from the business:** Sum the desired income and subtract the annualized income from other sources to arrive at an approximate level of income needed from the business. This is the income level that the business owner desires and expects from the business. A primary goal of the succession plan is to meet or exceed that expectation. If there is a shortfall in the future annual income generated by the business or proceeds from the sale of the business, a secondary goal of the succession planning process is to identify that shortfall for the business owner and to plan corrective action to eliminate the shortfall. To get an accurate road map for the

future, it is helpful to prepare inflation-adjusted projected income, expense, and tax statements several years into the future.

In addition to financial needs, business owners often have other expectations. Sometimes, business owners want more than simply enough income to retire comfortably. Since the business represents years of hard work and commitment, some business owners want to cash out for as much as possible. This desire should be considered as well. The calculation of future income will guide the risk and return for the replacement investments of sale proceeds.

Financial issues are often the primary concern for the business owner's future. But they are not the only concern. Owners need to consider their desire for future involvement in the business, investment, personal legacy and other personal values.

**Involvement:** Many business owners do not wish to simply walk away from the business from one day to the next. The level of continued involvement desired by the owner must be identified. Further, everyone should be aware of the involvement that the business owner wants after he or she has handed off formal responsibilities. Often this question is intricately tied to management succession (see Step 3: Management Succession).

1) Does the owner want daily involvement in the business? Would he or she like to remain involved as a sales representative, coordinator of special projects, or an outside consultant?

2) Does the owner wish to remain as an informal advisor to company management, or continue in a formal position on the board of directors?

3) Does he or she want to stay on as the chief executive officer indefinitely or reduce his or her involvement gradually?

This is not the time to struggle with management succession, which will be considered separately below. Right now, the owner needs to specify what level of involvement he or she wants in the future in the business.

**Investment:** To what extent does the business owner want to continue to be an investor in the business? Does he or she want a continued equity stake in the company? Would he or she like to remain the majority shareholder for the short term? Indefinitely?

Often a staged sale is desirable. A staged sale is when the business owner turns the company over to family members or sells to managers and/or employees over a number of years. Management responsibilities often shift in similar stages along with the risk and reward. Staged sales, however, are hard to do with outside buyers.

**Legacy:** Does the owner want the business to continue as a personal legacy to his or her life of hard work? Is it alright if the business ceases to exist as an independent entity? Does the owner have charitable intentions? Would he or she like to establish a charitable trust to allow for continued support of philanthropic organizations, schools, colleges or universities? What about trust funds for family members, children and grandchildren? Answers to these questions help define the personal legacy the business owner would like to establish. This legacy should be an important part of the succession plan, since it will be a significant part of the personal accomplishments that the business owner can enjoy when he or she is retired.

**Values:** What personal values are important to the business owner? Apart from their personal goals, most business owners have values that influence their decisions. For example, does the business owner value the business as a contributor of jobs and taxes to the community? Does

the business owner want the business to continue for the sake of the employees? Has he or she supported community programs such as the Boy Scouts or Girl Scouts, United Way, etc.? Is it important that these involvements continue?

**In summary:** The income needs, involvement expectations, investment, legacy desired, and personal values combine to create a set of the owner's personal goals for the succession plan. While all of these goals may not be met, the business owner must consider and recognize these expectations to achieve a satisfying outcome.

## Step 2: Goal Setting - Other Stakeholders' Goals

Family members, other owners, management and employees of the business will continue to have an impact on the business. As a result, the goals and expectations of these people are important to consider. Their active involvement in the process often helps them accept the outcome.

There are three distinct groups whose needs and goals should be considered. They are family, managers/employees, and other owners. The goal in this step is to gather information from people in all these groups. You may find it useful to write down other stakeholders' needs and goals on Worksheet 4 in the back of this book.

In many small businesses, these groups overlap. They can be seen as three overlapping circles.

**Family:** Family members have various levels of involvement in the business. Some family members are active in the daily operations of the business, others may be passive partial owners, and still others have no contact or involvement with the business.\*

**Family:** Family members have various levels of involvement in the business. Some family members are active in the daily operations of the business, others may be passive partial owners, and still others have no contact or involvement with the business.\*

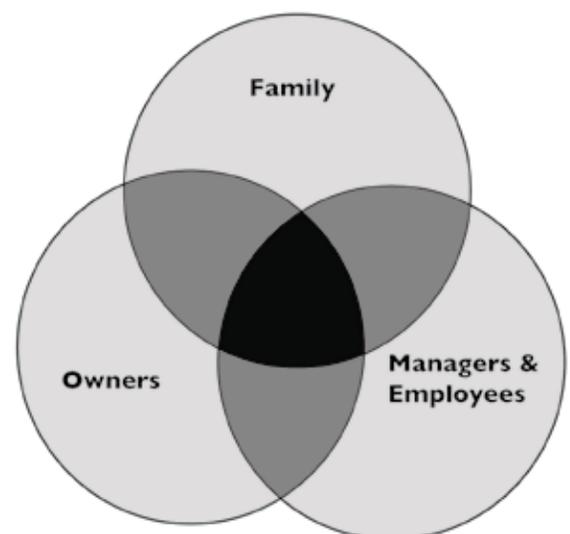
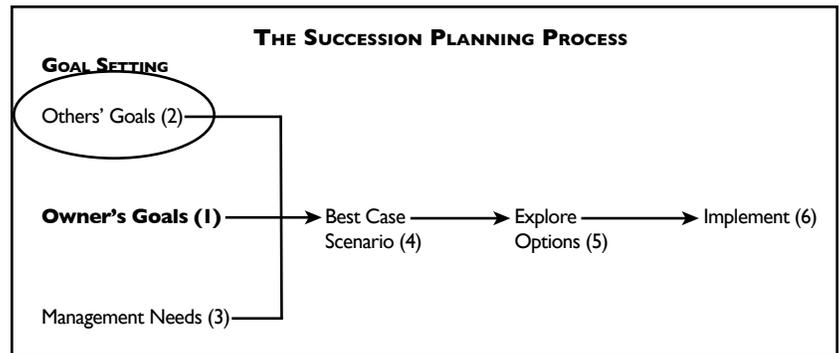
The business owner has a complex set of relationships with all these family members. The owner is not only a father, mother, spouse or sibling, but may be a supervisor, teacher and fellow shareholder. These last relationships will change as the business owner enters a new stage in life. The strain caused by change can be reduced by openly discussing hopes and expectations with everyone. There are a number of tools to surface the expectations of family members.

Family meetings can be useful for many reasons. Some ground rules can help family meetings run better. For example:

- Focus on the problem, not other issues with each other;
- Work toward mutually beneficial, win-win solutions; and
- Everyone needs to listen and respect the ideas and feelings of each other.

Family meetings should be planned with a formal agenda and have starting and ending times. Some agenda items might include:

- The needs and goals of everyone present;
- The needs, goals and hopes of the business owner;
- Discussion of the advantages and disadvantages of having a family business;
  - The current state of the business; and
  - The succession planning process that is being followed and a projected timeline.



**Stakeholders in Succession Planning**

\* This chart and information in this section draws on Mike Cohn, *Passing The Torch*, op. cit.

Sometimes an outside facilitator can help avoid conflict and keep the meeting focused.

Individual meetings with every family member can help the business owner understand the feelings that create differing expectations. Individual meetings should remain focused on the needs and goals of the family member. Topics should be discussed openly and honestly.

Notes should be maintained to remind the owner of what was said and learned. The meeting participants should be told in advance about what will be discussed so that they can prepare and think about their concerns. When such important meetings are a surprise to participants, they arrive unprepared and sometimes become uncomfortable which detracts from the meeting.

Surveys of family members can help them explore the issues before the meeting. They can be useful in part because everyone can consider the issues carefully in advance. Further, it is easier to identify concerns and expectations alone in the comfort of your home than when you are surrounded by family members in a meeting. Surveys and questionnaires should not take the place of the personal discussions. This interaction between family members typically leads to a deeper understanding, and it encourages a sense of personal involvement in the process.

**Managers & non-managerial employees:** Managers and non-managerial employees will have a continued impact on the business during and after the succession plan has been designed, implemented, and completed. The goals, expectations, and concerns of this group should be considered, especially if business continuation is important to the owner. Involvement in the process will help maintain the relationships necessary to continue a successful business.

Management succession will tend to be of greater concern to managers. However, any sincere ideas, concerns and suggestions should not be ignored in the ownership succession process. Sometimes, management and ownership succession have to be worked out simultaneously. For example, when the next generation of the family is not fully prepared for the job and will need to be trained by top management, those managers can be given “golden handcuffs.” Golden handcuffs are often in the form of stock, stock options, or phantom stock that will keep them motivated to stay with the business and encourage them to train the family successor (see Management Succession below).

Ownership transition is a time of instability. During such transitions management is often tempted to “jump ship” and join more stable competitors. This is especially true if they do not have hope that they will be rewarded for sticking with the company. If the managers are involved in the process and help determine the outcome, the temptation to leave is reduced. This crucial juncture is where many family businesses fail to make the transition from first to second generation.

*Individual meetings* with each of the top managers is an excellent way to find out what they expect and hope for the future of the business. Further, it shows them that their ideas and concerns are important for the continuation of the company. Finally, they will feel involved in the process rather than insecure as the foundations of the business shift under them.

It is often helpful for the participants to consider ownership and management succession issues in advance. A clear agenda should be maintained and followed. The owner should take time to explain his or her hopes for the future and the manager’s role in that future. It also should include an opportunity for managers to explain their hopes and fears for their roles in the future of the business. The retirement plans of key personnel should be discussed as well since their guidance and expertise could be crucial to the future success of the business.

*Surveys* can be excellent tools to start the discussion. Again, surveys should not take the place of personal discussions, but often written responses are more carefully considered and can be good reminders of what is important to the managers.

In all cases, careful notes should be taken and distributed to all participants. These notes will

serve as a collective memory of the issues raised and what was discussed. These notes will be reviewed as the process moves forward, to insure that the owner has not forgotten the needs and expectations of key managers.

*Group meetings* can be useful to update everyone on the progress made. They can also help everyone understand the process. Rumors always begin when change is in the air. Usually, they grow out of fear, and they are fed by a lack of accurate information. The saying that “Rumors expand to fill gaps in information” is all too accurate. Group meetings, with management and supervisors and sometimes all employees, can help to quiet rumors and keep everyone focused on the success of the business, instead of wondering “What if...?” Sometimes such meetings are helpful simply because the employees know that something is being done to avoid a potential crisis.

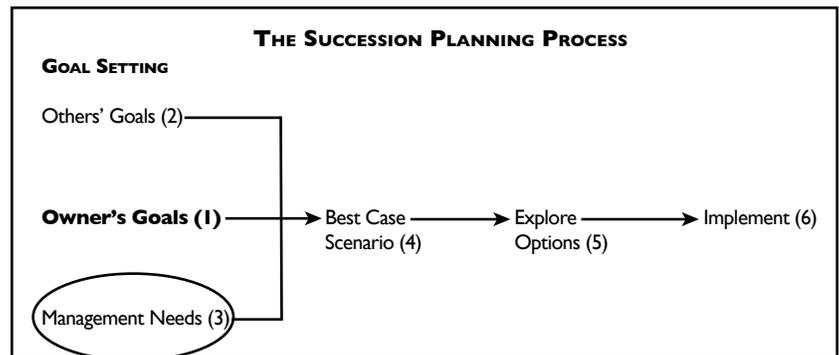
**Other owners:** The input, advice and concerns of other owners need to be considered. In these days of extensive litigation, it is especially important to insure that minority shareholders are aware of how the changes may impact them. These communications take a variety of forms, but should be approached carefully, as the possibility of minority shareholder litigation can become a serious problem. Competent legal counsel can help manage these communications and relationships. The issue of fiduciary responsibility is a serious one as the majority shareholder prepares to cash out. Of course, the main shareholder wants to maximize the value of his or her stock. However, main shareholders should keep in mind that conflict of interest can build mistrust and spoil an otherwise collegial environment and a good succession plan.

Family members, managers and owners may have goals and concerns that conflict. The conflict can be more complex when these groups overlap. A family member who is also an employee and owner may struggle to sort out his or her own feelings and expectations. Open communication and a commitment to the process of planning is the key to maintaining these relationships throughout the process. If all participants know the direction and time line of the process, they can participate on what they perceive as a level playing field.

**In summary:** The goal of step 2 is to gather information from everyone who will be affected by the succession plan. The concerns of these groups should be considered in relation to the goals and needs of the business owner. Simple involvement in the process will help to reduce the negative impact of the instability caused by change.

### Step 3: Management Succession

Management succession planning is necessary only where the business owner wants the business to continue after his or her departure. If a business owner plans to sell the business to an outsider, management succession becomes the concern of the new owner. However, when the business owner intends to keep the business independent and



closely held, or have a continued interest in the business, management succession planning is absolutely critical. Successful management succession planning will answer three questions: “What do I do?, Who can do those things after I’m gone?, and How can I get them ready?” The business owner should devise a plan to answer those questions and sketch it on Worksheet 5 at the end of this book. Here are some suggestions to get the process started:

**1. Assess the responsibilities, skills and relationships of the current owner.** The first step is to determine what the owner does. This may seem impossible since, after all, the business owner is responsible for everything! What makes this process more difficult is that few business owners have formal job descriptions.

Originally, the owner may have been the controller, sales agent, plant manager, customer service representative and the shipping department. As the business has grown, other people have been hired to take on some of these roles and responsibilities. The business owner has developed a job that fills in around the job descriptions of everyone else in the business.

- **Activities log:** One way to figure out what the business owner does is to keep a careful record of his or her activities. The log should include phone calls made and received, meetings held and attended, with their purpose and decisions made. Although it is not necessary to record daily meetings, be sure to take notes of monthly and quarterly strategic meetings, contacts with customers, suppliers, bankers and annual job reviews with employees.

- **Lists of job responsibilities:** Writing a list of what the business owner does may not be enough. He or she may perform tasks and make impromptu decisions outside of formal meetings. Therefore, it is advisable to have top management work with the owner to construct an inclusive report of his or her responsibilities.

It is also important to identify the business owner’s important relationships. This could include relationships with customers, suppliers, bankers and other investors.

**2. Assess the skills and abilities of the management team and potential successors.** Write down the skills and abilities of the top management team and potential successors. These lists should realistically summarize who does what and should begin with job descriptions. However, as mentioned previously, small businesses responsibilities tend to flow to those who can do the task rather than strictly by job description. The management team should make similar lists. Again, they will likely have a different perspective on their own and each other’s responsibilities.

**3. Ask the successors and management team what they would like to do in the future.** The management succession plan, more than the ownership succession plan, must consider the hopes and plans of the management team and potential successors. It makes no sense to shift new responsibilities to a long-time manager who also plans to retire soon. Further, if an important member of the management team does not want to take on new tasks and responsibilities, then he or she will not learn the skills necessary to perform those new tasks well.

**4. Find out what the management team will need to help train the successor.** If the business owner's chosen successor is not fully prepared, the management team must be ready to help train him or her for the new job. The management team may need encouragement to stay with the company through the transition and to share skills and knowledge with the successor. There are many ways to motivate such managers with special incentives. Some of these "golden handcuff" incentives are:

- **Incentive Stock Options (ISOs):** Stock options give key employees the opportunity to purchase company stock at a predetermined price for a certain number of years. This encourages the manager to be concerned about growing the stock. For example, ISOs are given to Bob, a key manager. The ISOs give Bob the right buy up to 1000 shares of stock for 5 years at the current value of \$20 per share. Thus Bob stands to benefit from any rise in the value of the stock and has an incentive to increase the value of the company. In the fifth year, if company stock is worth \$45 per share, Bob can exercise his option and buy 1000 shares for \$20,000 then sell the stock for \$45,000 and realize an immediate \$25,000 gain. Redemption agreements can require Bob to hold the stock for several of years, or redeem it only when he retires or leaves the company.

- **Phantom Stock and Stock Appreciation Rights:** Phantom stock and stock appreciation rights (SARs) can also link future compensation to the value of company stock. Neither phantom stock nor SARs require any actual transfer of stock. The manager is given a pledge for future payment of a benefit based on the appreciation in value of the company stock.

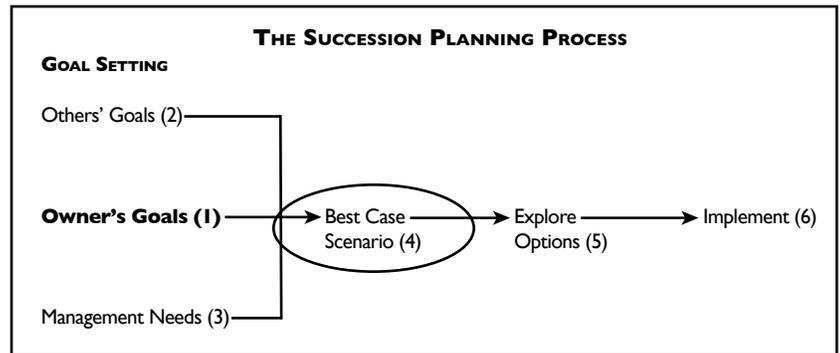
- **Non-qualified Pension Plans:** Non-qualified benefit plans can be designed to fit the needs of the business and executive. A non-qualified plan can be designed to keep top executives with vesting schedules and annual contributions.

**5. Combine the needs of managers and new responsibilities they will take on.** The final stage of management succession planning is to balance the needs and expectations of the managers and successors. Special emphasis should be placed on the training necessary to prepare people for new responsibilities. Further, it is important to consider how to "transfer" relationships to successors. Over time, a retiring business owner can help to cement a comfortable relationship between important clients, customers, suppliers, lenders and successor managers.

**In summary:** Management succession planning is necessary when the owner wants the business to continue as an independent company. It is the process that determines who will do the owner's job when he or she is gone. The skills, interests and future plans for top managers at the company must play a key role in management succession planning. Sometimes management succession and ownership succession planning go hand in hand as top managers expect "a piece of the pie" if they stick around through the instability of business succession and take on new responsibilities at the company.

## Step 4: A Best Case Scenario

After the appropriate information is gathered from the important groups, it is time to begin work on the “best case scenario.” In the best case scenario, the business owner begins to balance the needs and expectations of everyone involved and identifies priorities for the succession plan. The careful preparation and information gathered in the first three steps will be used to guide the creation of the best case scenario. This is often the most difficult stage of succession planning because it is where the diverse goals of the different participants must be pulled together into a cohesive plan.



The best case scenario is a summary of what the business owner wants, in consideration of the concerns, hopes, and expectations of everyone else involved.

The more clearly and carefully issues and concerns are prioritized in the best case scenario, the easier it will be to devise a successful plan. This should not be a pie-in-the-sky dream. The goal of this stage is to consider and balance the needs and expectations of everyone involved and decide which goals are of the highest priority.

**1. Review and summarize the needs and goals of the business owner.** These are not likely to be forgotten. However, reviewing them is a valuable exercise. After a thorough review, they should be summarized into a few paragraphs or a page.

**2. Review and summarize the needs and goals of the others involved.** The needs and goals of the other important people should be reviewed and summarized. Again, the ideal length is a paragraph or page for each key individual or group. These pages will prove invaluable in later stages of the succession planning process.

**3. Consider the implications of management succession issues.** Often, the goals and values just summarized do not adequately reflect what will be necessary to insure smooth management succession in the business. If continuation of the business is a high priority, then management succession issues are also a high priority.

**4. Design a unified set of goals for the succession plan.** This is the most difficult stage of goal setting. A business owner must consider everyone’s needs in relation to the needs of the business to arrive at a unified set of goals for the succession plan. These unified goals form the best case scenario. The business owner must realistically look at the goals of the people involved and the needs of the business in order to rank needs and goals. These judgement calls are a difficult challenge, but it is only through conscious priority setting that the inevitable conflicts can be handled well. If these decisions are made consciously, it will be easier to explain them to the people involved. At least, then, everyone will know that their needs were considered, and they will be more likely to accept the result.

The best case scenario should include:

- The expected annual income of the business owner in retirement, or the net amount after tax, the owner will need to get from the sale of equity to retire in the manner he or she expects.
- A list of who will own how much equity in the business. This might include a combination of family members, current owners, managers and employees.
- An explanation of who will hold what positions and responsibilities in the business and the training they will need to perform successfully.
- A summary of the desired level of involvement that the business owner wishes to have in the business and for how long.
- A summary of how other goals might be met. For example, a trust fund for children, grandchildren or for charitable contribution purposes.

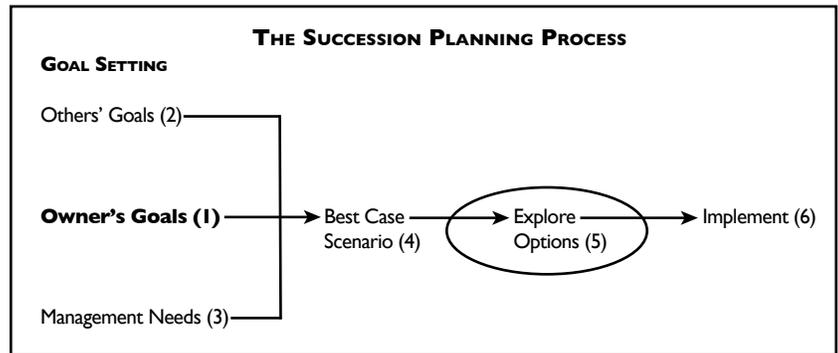
This best case scenario is not a blue print for the final plan. In fact, it is possible that the final succession plan will look altogether different. This plan is the initial starting point for discussions with professional advisors. The legal and tax implications of the various options must be considered before an outline can be drafted. Options that have not been considered might meet the goals of the various people involved. This is why the summaries of everyone's goals and needs are useful.

The best case scenario—Worksheets 6 and 7 in the back of this book—and the summaries of people's goals and needs—Worksheet 4—are the documents that will be used together to guide the creation of the succession plan. Sometimes, the goals desired will be met through means not considered. For example, the best case scenario may seek to put stock in the hands of top managers at the company. However, for tax and legal reasons, it might make sense to give them an equity interest through other means, like stock options, phantom stock, or an employee stock ownership plan (ESOP).

**In summary:** The best case scenario should unite the hopes and expectations of the key participants into a cohesive set of goals. These goals should reflect what the business owner would like the business to look like after he or she has exited. The best case scenario, as well as the summaries of people's goals, will be the starting point for finding the most appropriate technical solutions.

## Step 5: Explore Options

Step five of the succession planning process is exploration of the legal options. The options selected should be chosen to achieve the goals outlined in the previous steps. Too often succession planning begins with legal and tax options, and, when business owners start here, they typically come up with a technically solid plan that does not meet their personal succession goals.



This stage is where the business owner finds out his or her financial and legal limitations. At this point, it is important to realistically assess the financial condition of the company and its future. It may make sense to have an outside professional appraiser evaluate the company and provide an objective valuation. Frequently, the outside valuation is a disappointment. Business owners often over-value their business. This is an understandable mistake. The business is, indeed, more valuable to the business owner than it may be to others.

A qualified business appraiser can help determine an objective value of the business, and will be able to explain the benefits and limitations of each ownership succession option. Further, such professionals understand what is and is not allowed in the specific circumstances. A business owner who approaches a professional with his or her goals in hand will save time and money as opposed to one who begins the process without clearly defined goals.

To provide an idea of the options available, the next part of this book contains information on alternatives succession choices. These pages are intended to introduce the business owner to each option. They are not legal documents. While effort has been made to insure their accuracy, the law changes frequently as it pertains to many areas of succession and estate planning. For this reason alone, it is important to explore the options with a qualified advisor.

The options that follow are not the only options available. They are summaries of commonly used strategies. Many different options can be combined to meet the unique needs of every business owner. It is important to explore all of the options available, so that later, when the plan has been designed, the business owner does not find that there was a better way to achieve the same goals.

**Keeping the business in the family** is often the primary goal of succession planning. There are a number of ways to keep the business in the family. Some options are to gift shares to family members, establish trusts to provide continued income to the owner, or leave the stock to the next generation. Additional options include selling some shares to managers or the employees directly or through an Employee Stock Ownership Plan (ESOP). Any of these options permit the family to retain control while providing liquidity to the selling shareholder.

**Buy-Sell Agreements** are common tools in ownership succession. Buy-sell agreements can be arranged between or among shareholders and the business. They insure that each shareholder can sell his or her stock, and secure stable ownership among a small group of shareholders.

**Gifting shares** is widely used as a succession strategy because it helps reduce taxes. Generally, gifts are a part of an overall strategy for ownership succession. The shares can be given to family members or trusts for beneficiaries such as family members and charitable organizations.

**Trusts** are often used to provide continued income to the business owner and his or her spouse. After

the life of the trust, the assets can be given to beneficiaries such as family members, charitable organizations or others.

**Management Buyouts** are an excellent alternative for business owners who want the business to continue under current management, but also want liquidity and want to reduce personal responsibility for the business.

**Sale to employees** through an **Employee Stock Ownership Plan (ESOP)** or a **cooperative** are growing popular. Sale to employees allows the business to remain closely held and can allow for the tax-free rollover of proceeds into other diversified investments designed to provide continued income to the shareholder. The ESOP or co-op also allows the employees to share in the future success of the business. This benefit can motivate the employees to make the company more successful.

**Sale to outsiders** is often the choice of business owners who do not have successors within the company. It is often not considered “succession planning” since the new owner is responsible for the future of the business.

**Liquidation** is not traditionally considered “succession planning” because the business is not being passed on as an operating concern. However, in some circumstances, liquidation is the best way for the owner to meet his or her financial needs.

Each of these options – and they are described at greater length in the section on “Alternatives in Succession Planning” which follows – should be explored to figure out how they might be used as part of an overall strategy to meet the goals of the business owner. Many options can be combined into an overall plan that will meet the goals of the business owner and other stakeholders.

After all of the options have been explored, the business owner, along with advisors, can design and implement the chosen succession plan.

**In summary:** The full range of technical solutions should be explored with the owner’s goals in mind. It is most important to explore the wide range of technical solutions before designing the succession plan. Often, the same goals can be met in a variety of ways, each with different tax implications. Therefore, the full range of possibilities should be explored and discussed with a professional advisor to insure that the most efficient options are chosen.

## Step 6: Design and Implement the Succession Plan

Implementing the plan is the final stage in succession planning. The financial and legal process for each succession plan will be different. Consequently, the advisors and professionals who helped arrive at the final plan will help draw up the legal documents and contracts necessary to implement it.

The final step is different from the previous five. The first steps of this process help business owners come up with plans that fit well for them and their businesses. Therefore, each step had a clear objective and end point. Step six does not have a clear end point. Succession plans often need revision and modification. Tax laws change, the condition of the business changes and personnel changes. All these will impact the succession plan.

A good succession plan designed a few years ago may no longer be adequate for the current needs of a business or its owner. Therefore it is important to revisit and revise the succession plan regularly. With that in mind, some important steps should be taken after the plan has been designed.

1) Follow the direction of the attorneys and service providers to insure that all of the documents are drawn up, signed and filed appropriately. It is critical that the plan is legally and financially sound and written and filed appropriately. These legal documents establish the plan and make it legally binding. This may mean filing documents with the various courts, the state and federal governments, and, perhaps, the Internal Revenue Service. The most important concern at this stage is to insure that the documents combine to provide the desired plan, and that they are beyond legal reproach. It would be unfortunate to put forth the time and effort to design an excellent plan, only to find that technical mistakes caused it to lack legal standing.

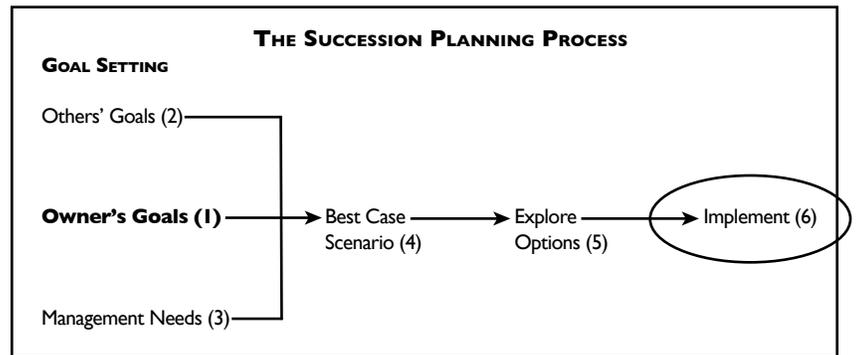
2) Design a summary of what the succession plan will accomplish and what the business will look like after the transition (Worksheet 7 at the back of this volume). This document should be drawn up in consultation with the professionals who helped design the plan. It will serve three important purposes.

First, it will force the business owner to summarize what has been accomplished in a clear and concise format. Since the document should be reviewed by the professionals involved, it will help the business owner insure that the plan is what he or she wants;

Second, the summary will help explain the final plan to other stakeholders;

Finally, the summary can also reassure customers, suppliers and lenders that an appropriate succession plan is in place and that the business will remain stable. Thus, they can continue to have confidence in the business.

3) Inform the important stakeholders of the particulars of the plan. It is especially important to explain the plan to the other stakeholders in the business. Since family members, managers and other owners helped design the plan, it is important to return to them and explain the outcome and how it addresses their goals. It is useful to meet and discuss the plan with key management, family members and other owners. This will help the business owner explain how and why he or she designed the plan. While the management, family members or other owners may not get all



that they wanted, if it is explained in a personal and logical way, the disappointment will be easier to digest. Further, it will show, above all else, that the business owner is concerned about their future.

4) Revisit the plan regularly. It may make sense to set a date every year to meet with the professionals who helped design the plan to insure that changes in the business, tax law and family situations do not require changes in the plan. Sometimes when the business owner sets up the plan, he or she assumes it is complete and forgets about it. The problem with this approach is that circumstances and laws change. Such changes may mean that the original plan is no longer legal, or does not offer the originally desired tax advantages. It is therefore important to give the succession plan a regular “check up” to make sure that it is still what the owner wants.

In addition, some important events should trigger a visit to the owner’s service professionals for possible revisions in the plan. These include:

- Divorce or remarriage of any of the primary participants in the plan. When the business owner, key beneficiaries or top management employees involved in the plan get divorced, it is important to make sure that the plan is updated appropriately. It is especially critical to change beneficiary names when the business owner or beneficiaries are divorced. For example, a trust established to benefit an owner’s first spouse may remain in effect unless it is changed or a divorced business owner with a retirement plan who changed its beneficiaries upon the divorce to his/her children may not realize that upon remarriage the second spouse is automatically the beneficiary of the retirement plan, superseding the designation of the children as beneficiaries.

- Death, disability, retirement or other departure of any of the stakeholders involved. The death, disability, retirement or departure from the business of any of the key stakeholders involved can change the ideas that guided the creation of the succession plan. The list of key participants often includes spouses, children, siblings, key management and other owners. This is especially important when buy-sell agreements are used. For example, the departure of one participant will lead to the repurchase of those shares. As a result, the funding mechanism for future purchases of stock must be revised to insure adequate cash to realize the next transaction.

- Substantial change in the profits of the business. A succession plan designed to insure a smooth ownership transition for a small business with moderate profits may not be sufficient for a larger business with substantial profits and vice versa. Three important changes may be necessary: (1) revise the formula for the business valuation, (2) insure that strategies to fund the repurchase of shares are adequate and (3) insure that the plans for reducing taxes will still be effective.

In the end, the succession plan will not be fully implemented until the business has completely changed hands. Therefore, it must be recognized that the plan should be revised to meet the needs of the owner, business and others involved until the transition is complete.

**In summary**, the final step in succession planning is to implement the plan. However, once established the succession plan should not be simply forgotten. The management succession plan must be implemented, usually over a number of years, sometimes in conjunction with the ownership transition. The ownership transition plan should be revisited regularly, as well as when significant events change the circumstances surrounding the plan. In particular, the succession plan should be revised when business conditions change substantially or when important participants leave the company or are divorced or remarried. Finally, the succession plan should be revisited on an annual basis to insure that tax law changes have not negatively impacted the plan.



## Doing Succession Planning: An Example

Twenty years ago, two brothers, John and Charles, opened their own business, “King Precision Machinery.” Early on, it was a struggle, and they disagreed over the direction of the company. John, the older brother, knew more about the industry, so they decided he would own 52% of the stock, leaving 48% with Charles. John also had more cash to invest early on. His total investment in the business was \$120,000 and Charles put in \$100,000.

The business, which supplies precision metal treatment machines to makers of computer parts, has done well. Its value has grown to approximately \$3.5 million. Their market position seems strong and the future looks good as their customers make “metal boxes” for new personal computers and rack mounted high-tech equipment.

John is 50 years old and Charles is 47. Both recognize the need to develop a succession plan. Charles would like to retire by the time he is 55 while John would like to continue running the business and remain partially involved for a long time to come. Each of the brothers is married. John and his wife, Laura, have three children and Charles and his wife, Colleen, have 5 children.

John’s children chose not to become involved in the business and have started careers in other areas. Charles’ kids, on the other hand, have worked at the business over their summer vacations. His oldest son, Ralph plans to join the family business full time when he graduates from college next year.

John and Charles started the succession planning process a little over a year ago. They held family meetings and met with their top managers. Here is what they found:

### John’s goals

John wants to enter semi-retirement when he turns 65. Ideally, he will remain in charge of the business and run its day-to-day operations until that time. Then, he would like to step back from the day-to-day work, but work on special projects and remain chairman of the board. He wants to maintain ownership and his current income for the foreseeable future. Should anything happen to him, he wants to insure that his wife is secure.

John would also like to see the company remain family-owned and has not given up hope that his children will become actively involved.

### Charles’ goals

Charles wants to retire early and enjoy his retirement. He would like to retire at age 55 and maintain no active involvement in the business. He wants to insure that his family is taken care of

and his son Ralph has a chance to take over the business if he demonstrates the ability. He also wants to insure that his children can go to college and are financially secure until they are on their own. Charles would also like to keep the business family owned, but is more concerned about it remaining stable and strong.

He wants his investment to provide solid income to his family and offer them both a professionally and financially rewarding career if they choose to get involved in the business.

### **The management team's goals**

Four of the top 5 managers at King Precision are all in their early or mid-forties. The fifth is 37. They all hope to remain with the business for the foreseeable future and have no plans to retire any time soon. They are capable managers, but none show the "total knowledge" necessary to take over the top spots from John and Charles.

Most of the members of the management team would like to own part of the business at some point and three of them would like to become President after John and Charles exit the company.

### **The Best Case Scenario**

After considering the goals of the key people involved, the King brothers came up with a "Best Case Scenario." Ideally, their best case scenario called for the business will remain closely held, and owned primarily by the King family or trusts held in their names. This will provide continued control over the future of the company, management decisions and who will be the top managers. Some ownership will be shared with top managers and other key employees as seems appropriate. Both John and Charles want to establish trusts to benefit their family members. The trusts would hold stock that would be distributed in small portions or in a big contribution if something were to happen to them.

In addition, John wants to set up scholarship trusts for his college and a shared trust for the high school they both attended. The trusts could sell the stock first to family members, then the company, then managers or key employees.

John would remain President and Chairman of the Board, until he turns 65 in fifteen years. Then he will retire from day-to-day operations and hand off control to one of the top managers or Charles' son Ralph. Charles will retire in eight years when he turns 55. Charles' responsibilities will be spread out among the top management team and his son Ralph at that time. This will give the top management team another 7 years with John at the helm to figure out who should take over the top spot.

## **The succession plan**

John and Charles went to visit their chosen succession planning advisor and discussed their best case scenario. They discussed a number of alternatives. The provider gave them additional resources to help them understand the alternatives and met with them again a month later.

In the end, here is the plan they came up with:

### **John's family**

John set up a series of trusts. He established a separate trust for each of his children and another trust for his wife. He also established a scholarship trust for his college and a shared trust for his high school. John and his wife will each gift the maximum amount of stock to each of the children each year until all of their trusts have \$100,000 worth of stock in them. At that time, the children will all have control over the trusts and can withdraw the stock or sell it to the company in increments. John's college will receive \$500,000 worth of stock and can also sell the stock in small increments.

John will contribute \$250,000 worth of stock to the shared scholarship trust for the prep-school which will have the same right to sell stock, first to family members, then the company, then managers.

John's trust for his wife will hold all of their assets and provide them with an annual income for the remainder of their lives. At the second death, the assets will go to the chosen beneficiaries, their children. The two scholarship trusts will reduce their income taxes during their lifetimes as both the college and prep-school are qualified charities.

### **Charles' family**

Charles' plans for his family look very much the same. He established a \$100,000 trust for each of his children except Ralph, who will be given the stock directly. Charles will contribute \$100,000 of stock to the prep-school trust. The remainder will go to a trust which will provide continued income to Charles and Colleen, then give the remainder to their children.

### **The Company**

These trusts fulfill the brothers' personal goals, but leave the company with a potentially huge liability to purchase the stock from them. While each trust has restrictions on the amount it can sell each year, and while it is possible for family members and managers to buy the stock themselves, the King brothers needed to find a way for the company to reduce the cost of buying stock from the trusts. They decided to establish an Employee Stock Ownership Plan (ESOP) to achieve this end. The two main benefits of this strategy were that the company could

purchase the stock from the trusts out of pretax earnings and could use annual “profit sharing” contributions to do it, thus changing a current cost, rather than adding a new one.

Both of these benefits are possible because the ESOP is a qualified retirement plan for the employees, like a 401(k). This means that contributions made to the ESOP for the purchase of company stock are accounted for as a retirement benefit for employees. The company had made substantial contributions to a “profit sharing pension plan” before, so the additional cost of the ESOP is minimal. It simply shifts future contributions from the profit sharing pension plan to the ESOP. (For more information about ESOPs, see Alternative 6). Since the company board of directors appoints the ESOP trustee, the company is still controlled by the other shareholders, the family and management. Finally, the brothers put buy-sell agreements on all of the stock shares that restrict ownership to family members, current employees, the company or the ESOP. The price at which shares will exchange hands is the fair market value as determined by the annual ESOP valuation.

The succession plan designed by John and Charles will leave the company with a number of alternatives. Further, their children will have a chance to own and work in the family business and they will leave long-term personal legacies at their prep-school and John’s college. Each of their children will be well taken care of and their spouses will be financially secure.

# 3. Strategies and Tools in Succession Planning

## Introduction

This part of *An Owner's Guide to Business Succession Planning* is designed to introduce owners to some of the common alternative strategies and techniques used in succession planning.

The information that follows is not intended to make the owner into an expert on any one alternative. It will simply outline some of the technical solutions which may fit into the succession plan. Further, it is not a comprehensive list of the alternatives available. As tax laws change, new possibilities open and others close.

This section can be viewed as a succession planning salad bar. In general, each alternative explained can be combined with others to make it fit the owner's goals. Our goal here is simply to introduce owners to the contents of each possibility. It is up to the owner to explore in greater depth, with a professional advisor, the alternatives that are of most interest to him or her.

Each alternative has its own strengths and weaknesses. Without a solid, well considered goal, it is easy to get excited about one possibility without fully exploring the many ways to achieve the same goal.

A number of additional resources are listed at the end of this book. Many provide excellent and up-to-date information on the alternatives. In particular, Mike Cohn's *Passing The Torch: Succession, Retirement and Estate Planning in Family Owned Businesses* can be recommended as a general resource in succession planning. Also, the *Field Guide to Estate Planning, Business Planning, & Employee Benefits*, by Donald Cady, published regularly by National Underwriter of Cincinnati, Ohio is an excellent, up-to-date resource, as is the *Family Business Sourcebook II*, by Craig Aronoff, Joseph Astrachan and John Ward. (See Section 4 for more information on additional resources).

## I: Valuation - How Much is My Company Worth?

One of the most important steps for a business owner looking to transition out of his or her company is to determine what it is really worth in the market. That means investing in a qualified and thorough valuation of the company. Many owners look at the added expense of professional valuation as an unnecessary waste of money. They think that they already know the value of the business. Unfortunately, what the owner believes to be the value of the business is not necessarily what someone else would be willing to pay for it. This can be due to several factors:

1) Much of the value of a small business is a result of the time, energy, and skills of the owner. However, if proper planning is not done, once the owner exits much of the value may be lost.

2) Business owners are often very busy with the day-to-day tasks of running the business. Therefore, they may not have the time to take a step back and think objectively about the value of their business.

3) A business owner may hear of a similar company having recently sold for a certain amount, or may have gotten prices from brokers who want to sell the business, or offers subject to "due diligence." An owner should always look at these numbers as not necessarily representing what the company may be worth in the market.

4) A business will almost always be more valuable to the person who has spent the better part of his or her adult life building it than it will be for others.

The standard rule of thumb is that any time there is a transaction involving all or part of the business, then a valuation is recommended. The good news is that once a full valuation is done, it can be updated at a reduced cost.

Essentially, the value of a business is what someone else is willing to pay for it. Some buyers are willing to pay more than others. For example, competitors, customers, or suppliers may be interested in buying a business in order to expand into new markets, diversify, or expand. They may be willing to pay a premium to do so. This is what is called Strategic Value, and is generally the highest value that an owner can hope to get for the business. Conversely, those buying businesses to run as stand-alone operations – that is, strictly as a financial investment – will typically pay less because they generally are looking at the cash flow of the company. Then there are bottom fishers looking to buy a good business for as little as possible simply because the owner has to sell.

If an owner sells to key managers or employees, the general rule that applies is Fair Market Value. Fair Market Value can be defined as "... the price at which property changes hands between a willing buyer and a willing seller when each is under no pressure to act and both have reasonable knowledge of the relevant facts." Recently, the idea of Fair Value has been gaining ground. Fair Value is essentially a "qualified" Fair Market Value in which a transaction's subjective facts are taken into account.

If an owner is planning on transferring the company to family members, he or she is generally not trying to maximize the price of the company. For example, few parents want to saddle their children with large amounts of debt. Consequently, when contemplating this type of sale, the lowest "defensible" value (one that can withstand IRS scrutiny) will be preferred. This is so that the IRS will not consider the transaction to be a gift and apply gift tax rates.

When appraising a company, a valuator generally uses one or more of the following approaches:

1) Asset Approach - Looks at the market value of the assets on the balance sheet. It can also take into account items such as goodwill.

2) Market Approach - Compares a business to recent sale prices of similar companies in same and/or similar industries and conditions (company size, geographic area, etc.).

3) Income Approach - Looks at the income the business can produce. This approach utilizes projections and other economic factors. When using this approach, income and expenses need to be normalized. The most common adjustment is to identify "excessive" compensation (multiple country club dues, luxury company car, company-owned boats, condos, etc.) for the owner that is added back to the value of the company.

Which approach is used depends on the type of business, and the purpose of the valuation (as discussed above). As most businesses don't fit neatly into any category, a valuation may utilize two or more these approaches in which an average between them is used.

Once the base value has been determined, there may be premiums and discounts. A valuation may apply a premium or discount to the value of an asset. The most common example of this is when there are multiple shareholders that hold unequal amounts of stock. If a business worth \$1,000,000 has one owner with 70% and another with 30% of the shares, the 30% owner's shares are not worth \$300,000. This due to the fact that the minority owner has essentially no control over the business; he or she cannot elect the board of directors, control budgets or business plans. A minority position carries a discount. Shares for which there is no ready market will carry a "lack of marketability discount." On the other hand, selling a majority stake can command a "control premium."

Most conflicts that occur out of the sale or transfer of a business are directly related to the value

placed on the business. That is why it is essential that a proper, and full, valuation be performed on a business. It is one of the best insurance policies an owner can have.

## 2: Keeping It in the Family

Many family business owners want to continue family ownership of the business. Unfortunately, 70% of family businesses do not survive to the second generation. A good succession plan can allow a business owner to pass the business on to family members while minimizing taxation. A variety of strategies can be used to pass on the business. The tools available should be used to form a cohesive overall strategy for ownership and management succession.

**Gifting stock** is an alternative that is widely used and can completely avoid taxation on much of the value of the business. Often, gifts are used along with other tools for an overall strategy to pass on the business. Information on gifting is available in Alternative 3.

**Trusts** are another tool which can help to reduce taxation, provide continued income to the former owner and his or her spouse, then pass the business on to the next generation. Information on trusts is available in Alternative 4.

**Selling to a family member** should be explored carefully. IRS attribution rules can make this simple alternative much more complex. The parties should arrive at a realistic, legally defensible value for the business. A valuation performed by an independent, qualified valuation advisor may be very worthwhile. Remember, the IRS is not obligated to respect valuations it does not consider reasonable. A low valuation may cause the IRS to claim that there is, in fact, a gift being given, on top of the sale of the business. A high valuation may saddle the business, or family member with excessive debt. Further, IRS attribution rules complicate the process. The process should be treated very carefully, as the proceeds could be considered by the IRS to be a dividend payment, or a gift to the family member.\*

Selling a business to a family member may, in effect, maximize taxation.

- The purchase of the business, whether directly by the family member or through the business, will be done in after tax dollars. This means that the business may pay as much as \$1.52 per dollar of capital purchased. (This assumes a 34% business tax bracket. The business must make \$1.52, pay \$0.52 in taxes and have \$1 left to pay for stock or assets). Further, if the business or family member has to borrow funds to acquire the assets or stock, there will be interest on that money as well.

- The owner will pay capital gains taxes on the gain realized at the sale of the business, reducing the after-tax value of the business to the owner.

- When the unused portion of the proceeds from the sale of the business pass into the estate of the original owner, they will be counted in the overall estate. Therefore, estate taxes will be taken out before the estate is passed on to the heirs and beneficiaries.

**Grantor Retained Annuity Trusts (GRAT)** can move assets into a trust. After the trust termination, it will be outside the estate and thus reduce taxes. A business owner can establish a GRAT that will provide continuing income to the business owner and his or her spouse. When the fixed length or lifetime annuity expires, the assets of the trust are passed to the beneficiary – the next generation or a second generation – further avoiding taxes.

**Supplemental Executive Retirement Plans (SERP)** can provide income to a retired owner, and reduce taxation. A SERP is an unfunded liability of the business. The firm pledges to pay a certain amount of income to the retired executive for a number of years. Since this retirement plan pledges

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\* Much of the information included in this section is from Chapter 25 of Mike Cohn, *Passing the Torch*, op. cit.

future income of the business, it will reduce the fair market value of the business. The business can then be sold for a reduced price to the successor generation, gifted directly, or passed into a trust. It is important to establish the SERP before the sale of the business, as the IRS can rule that the SERP is a payment for purchase of the business, hence disallowing the corporate deduction.

**Family Limited Partnerships** may be used to split the value of the business into income, equity and control functions. Once split, the owner can sell or gift the equity assets to the next generation. In this way, the business owner can retain control. The limited partnership units receive a greater discount in these transactions than the company stock by itself. The Family Limited Partnership is especially useful in a long-term strategy for transferring ownership. The ability to use it is one of the many advantages to timely succession planning.

**Selling or gifting rapidly appreciating assets** is a technique that can be used to achieve the same goals as the Family Limited Partnership. By shifting ownership of assets that are likely to increase in value, the owner of a business can transfer the assets at a low value, through gifting or sale, and the appreciation in value will be in the ownership of the next generation, avoiding taxation on the first generation. This approach, too, can be of tremendous value over many years.

These alternatives are some of the many tools which can be used to keep the business in the family, while reducing taxation. All of the alternatives have complex tax implications and should not be established without proper legal and financial advice.

### **3: Buy-Sell Agreements**

Buy-sell agreements are a useful and flexible way to plan for ownership succession. A buy-sell agreement is a legally binding agreement between or among shareholders and the company that requires the shareholders or the company to purchase the stock of the business owner. The method used to determine the stock value is usually written into the agreement and the restrictions that the buy-sell agreement places on the stock are often recorded on the stock certificates themselves.

There are three types of buy-sell agreements and a wide range of methods to fund them.\*

#### **Stock Redemption**

A stock redemption occurs when the business itself purchases stock from the exiting shareholder. Usually, the business purchases the stock at a predetermined price or at a price based on an agreed-upon formula specified in the buy-sell agreement. Often, after the stock redemption, the business will hold the stock in the company and use it later for other purposes. In the mean time, the redemption of stock serves to concentrate corporate ownership in the hands of the remaining shareholders.

**For example:** *Kevin owns 90 percent of the stock in his business. John owns the other 10 percent. When Kevin's redemption agreement with the company was triggered, his family sold his stock to the company at the predetermined price. Now, because all of Kevin's shares are retained by the company as treasury stock, John owns 100 percent of the stock outstanding. So John has become the sole owner of the company.*

This simple example demonstrates the concentration effect of stock redemption plans. In the example, it was clearly the goal that John become the owner of the business. However, the concentration effect may have less desirable impacts where stock ownership is not so straightforward.

**For example:** *Kevin owns 51% of the stock and he has spread the other 49% of the stock between three top managers and his two sons. The sons and managers each own 9.8%. When the company redeems*

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\* The information in this section is from Mike Cohn, *Passing the Torch*, op. cit., and Stephan Leimberg, Morey Rosenbloom, and Joseph Yohlin, *The Corporate Buy-Sell Handbook, An Essential Guide to Business Succession Planning* (Chicago, IL: Dearborn Financial Publishing, 1992).

*Kevin's stock in this case, everyone is left with 20% ownership. Thus Kevin's two sons will not own a majority of the company.*

Aside from these issues of share concentration, how to fund a redemption agreement is a central question. A plan to fund the redemption agreement will help avoid serious financial crisis for the business. Some possible strategies are presented below.

Stock redemption agreements effectively require total redemption of all of the shareholder's stock at once. Otherwise, the IRS may argue that the purchase of stock really amounts to a dividend and may require taxation of the proceeds as dividends, rather than as a capital gain for the shareholder. This tax difference may be quite important and, due to attribution rules, can be complex.

### **Cross Purchase**

A cross purchase agreement is between shareholders. The agreement is to purchase the shares of one another upon certain trigger events. These agreements generally guarantee that upon the death, retirement or disability of a shareholder, the other shareholders will purchase his or her stock at a predetermined price or according to a predetermined valuation formula.

**For example:** *If, in the above example, Kevin had created a cross purchase agreement with each of the other shareholders, he could have designed a plan where his two sons purchased 16% each and the three managers purchased the remaining 19%. This plan would leave the two sons with a combined 51.6% of the stock, maintaining family control of the business.*

Cross purchase agreements also require careful funding. The cross purchase agreement requires that each shareholder plan to have sufficient funds to purchase shares from each of the other shareholders.

### **Wait-and-see plans**

Wait-and-see plans combine the redemption and cross purchase strategies outlined above as they first allow the other shareholders to purchase stock and then require the company to redeem the remaining shares. The wait-and-see approach allows greater flexibility for the shareholders but complicates the funding process. The company may not know how much stock each shareholder will purchase, therefore, it might over or underestimate the cost to buy the rest of the stock.

### **Funding a buy-sell agreement**

The idea of buy-sell agreements is simple. But the funding question makes them more complex. Let's explore the funding choices.

**Cash.** Cash is the simplest way to fund buy-sell agreements. It simply takes cash out of current available funds. Unfortunately, it is also the most risky. Buy-sell agreements can drain a company's cash reserves and leave the business and other stockholders without sufficient funds to maintain regular operations. Further, if the business is suddenly forced to spend all of its available cash to purchase stock, other important plans may be put in jeopardy.

The savings of the shareholders and retained earnings of the business may be depleted. No matter who purchases the shares, when funding is done through cash, it must always be done in after-tax dollars. This means that to purchase \$1 of stock, more than \$1 of pretax income must be generated.

**Debt.** Borrowing the funds to purchase stock also requires the earning of more than \$1 for every \$1 of stock purchased. The cost of debt will likely be much higher than the original cost of the stock as it will require payment of interest. Further, the principal payment will be after tax, so the company must commit more than \$1 of pretax earnings to pay \$1 in principal.

Debt is risky for stock redemption and cross purchase for two additional reasons. The business

or stockholder may have to pledge assets as collateral for the loan to purchase shares. Thus, these assets cannot be leveraged for other purposes. In addition, the business takes on debt without any corresponding increase in the value of the business causing its value to fall, which may make other shareholders unhappy. For the shareholder in a cross-purchase agreement, borrowing may require a pledge of personal assets as collateral, as the value of company stock may be too volatile following the loss of the main shareholder and top manager. Further, if both the shareholder and the company take on debt simultaneously, the value of the company will drop just after the shareholder has taken out a loan to buy it.

**Sinking fund.** A sinking fund is a separate fund, usually invested in short-term securities or bonds, to which contributions are made over a number of years in order to buy the stock. This is also a rather simple approach. Sinking funds accumulate cash for the purchase over a number of years. This means that when the purchase is required, it does not suddenly impact the business or shareholder. The other shareholders can also make special contributions to bank accounts or money market funds for the purpose of buying stock from selling shareholders.

The tax consequence of these approaches is similar to the cash approach. The individual and business will make contributions to this fund from after tax-income. To purchase \$1 of stock will require more than \$1 of pre-tax income. Further, the fund will be considered an asset of the business. As a result, it may increase the value of company stock.

**For example:** *A \$5 million business has prepared for the departure of the 60% shareholder with a sinking fund worth \$3 million. The \$3 million may increase the value of the business, yielding a new value of \$8 million. Thus the liability of the company has increased from the original \$3 million to \$4.8 million. Remember, the IRS is not obligated to respect the previously agreed-upon formula for the valuation.*

**Installment Payout.** An installment payout is an attractive and simple alternative. The owner sells all owned shares to the company today, and the company signs a contract to pay the value of the stock to the shareholder over a number of years. This reduces the cash drain and leaves the business some cash for alternative uses. This approach will require that interest be paid on the balance and principal payments will be from post-tax income. Interest payments will be tax deductible.

Installment payouts leave the shareholder and/or beneficiaries as creditors to the company. Therefore, the owner or family cannot diversify its investment and reduce risk. Consequently, if the former owner has handed off management of the company, he or she is no longer in control of that large investment. If the installments are stretched out over a large number of years, say 15, the IRS may argue that since the owner continues to share in the entrepreneurial risk, he or she continues to be a shareholder and therefore they may tax the payments as dividends, instead of capital gains. If the selling shareholder desires security in the form of liens on assets, those assets cannot be leveraged for other business purposes. Therefore, the installment payout possibility takes on some of the worst characteristics of the debt approach and the cash approach.

**Private Annuities.** The business can provide for a special private annuity for the life of the shareholder or a beneficiary. This approach does not allow for any collateral to be pledged, so the former owner continues to share in the risk. In this case, payments made by the corporation are not deductible and the payments will come out of post-tax company profits for the length of the annuity.

**Life Insurance.** A number of possibilities exist with life insurance. It is possible to use life insurance for the purchase of shares from the exiting shareholder. Insurance can be used whether funding a cross purchase plan or a redemption. The main difference is who owns the policy.

In cross purchase agreements, all of the shareholders involved should have policies on all of the other shareholders to help them meet their cross purchase commitments, should the need arise. Obviously, this can require a number of separate policies. The shareholders will pay the premiums out

of their post-tax income, so the business may have to increase compensation to allow for post-tax purchase for each shareholder.

**For example:** *If there are three shareholders (A, B and C), there will have to be 6 separate policies. Shareholder A will need a policy on shareholder B (policy 1) and shareholder C (policy 2). Shareholder B will need a policy on shareholder A (policy 3) and on shareholder C (policy 4). Shareholder C will need a policy for A and B, as well (policies 5 and 6).*

For a redemption, the business can take out corporate-owned life insurance (COLI) to cover the purchase of stock from the shareholders. But the cost of insurance premiums is not tax-deductible to the company, if the company is the beneficiary. Again, however, the value of the insurance policy can impact the value of the company, so the amount required to purchase the shares will increase. Some additional questions include how much insurance to take out - how much will it cost to cash out the shareholder?

There are a wide range of alternative strategies for funding buy-sell agreements. Regardless of the chosen mechanism, buy-sells are useful tools to keep businesses closely held.

## 4: Gifting of shares

Gifting of shares is an excellent long-term succession strategy. It is a good reason to begin the process early. Gifts of stock can be among the most attractive ways to avoid taxation while passing on the value of the family business. Shares of stock can be directly gifted to direct decedents, with various tax implications. Shares can also be gifted to separate legal trusts that can then benefit the owner, family members or charitable organizations. Each of these options has different tax implications.

**Gifting to each family member.** Each individual is allowed to make a tax-free annual gift to family members up to the amount of the annual exclusion—\$12,000 in 2008. (See the addendum in the back pocket of this book for updated gift tax information.) This means that a business owner can transfer the annual exclusion amount worth of stock each year to each heir. If the business owner is married, both the owner and his or her spouse can each give the annual exclusion amount. Further, the business owner and spouse can take advantage of the unified gift tax lifetime credit to make gifts over and above the annual exclusion amount up to their lifetime limit. This credit means that amounts up to the lifetime limit can be gifted without paying gift taxes. Amounts gifted are no longer part of the owner's estate and, therefore, are not subject to estate taxes.

**For example:** *Assume that the annual exclusion amount is \$12,000 and the lifetime gift limit is \$1,000,000. Bob and his wife, Sheila, own a business worth \$3 million. They want to pass the business on to their three children. Bob and Sheila, can each take advantage of the annual gift exclusion and give each of their three children a total of \$24,000 worth of company stock each year. The total gift to the three children each year equals \$72,000. Over 14 years, Bob and Sheila can gift \$1 million worth of stock to their kids. Then, they can take advantage of their individual \$1,000,000 lifetime gift limit (\$2,000,000 total) to pass on the remaining stock tax free.*

The children will receive a carry-over basis on this stock (that is, Bob and Sheila's original basis) and it will be subject to capital gains if and when they sell their shares. If the stock passed through the estate, the children would receive a step up in basis on the shares. However, Bob and Sheila will have transferred all the future growth to their kids, and that growth will not be subject to any transfer tax.

**Gifting to a Trust.** Individuals can also make annual gifts to trusts. The taxability of such donations depends on the status of the trust and the beneficiary. A revocable trust, where the donor has

rights to the trust asset, are taxed differently from irrevocable trusts. A revocable trusts remains in the control and possession, and therefore the taxable estate, of the grantor, the person who sets it up and makes contributions to it. Donors have limited rights to control or alter irrevocable trusts; consequently, the trust assets are excluded from the donor’s taxable estate.

There are many types of trusts that can provide an ongoing stream of income to the business owner or a family member for a finite period, or until death of the beneficiary. At the end of the term or death of the beneficiary, the assets can distributed to the descendent’s heirs or donated to a charity.

## 5: Trusts

Trusts are widely used in estate and succession planning. The basic benefit of trusts is that the assets contributed by business owners to some trusts can be excluded from their estates. This will reduce the size of the estate and the amount of taxes paid.

There are many different types of trusts. Some of the most common trusts are explained briefly here. The tax provisions that surround different types of trust change frequently. Therefore, it is important to consult appropriate legal counsel before you establish any sort of trust.

The basic idea of a trust is to shift the assets of the business owner out of the estate, which reduces the estate taxes paid. Further, a trust can be a way to make use of the applicable gift tax credit while the business owner is alive, thus passing up to the lifetime gift limit in assets to the next generation free of estate tax. The applicable gift tax credit allows an individual to pass up to the lifetime gift limit worth of assets without paying taxes. See the Addendum in the back pocket of this book for updated gift tax information.

**For example:** Assume Patrick dies in January and his wife, Caroline, dies in December of the same year. Assume the lifetime gift limit equals \$1,000,000, the estate tax threshold is \$3,500,000, the estate tax rate is 45%, and the marital deduction is unlimited; i.e. spouses inherit their deceased spouse’s estate tax free. Patrick’s estate is worth \$4,500,000. If Patrick leaves his entire estate to Caroline (Option A in the chart), no estate taxes are paid upon his death because of the unlimited marital deduction. If the estate is also worth

Estate Worth \$4.5 million		
Option A	Option B	
-----First Death-----		
Taxes = \$0	Taxes = \$0	
\$4.5 million to spouse	\$3.5 million to spouse	\$1 million to trust
-----Second Death-----		
Taxes = \$450,000	Taxes = \$0	
\$4.05 million to children	\$4.5 million to children	

*\$4,500,000 at Caroline's death, estate taxes of \$450,000 are due upon her death, assuming she has not used any of her applicable gift tax credit. This will leave \$4,050,000 for Caroline and Patrick's children. On the other hand, if during his life or at death, Patrick sets up a trust and makes a gift of \$1,000,000 to that trust (Option B in the chart), taxes are reduced to zero, leaving \$4,500,000 to their children. This tool represents a tax saving of \$450,000.*

It is possible to design the trust so that income generated from trust assets are given to the spouse for the remainder of his or her life. Further, the beneficiary of the trust assets can be assigned by the business owner upon establishment of the trust. The remaining assets of the trust can be assigned to a charitable organization, children or grandchildren or just about anyone else.

Because there are so many different types of trusts, it is difficult to design one chart, or one concise listing of how and why they are used. However a brief description of some of the most common types of trusts follows. Often trusts can be combined with life insurance to establish creative ways to reduce taxes and provide benefits to the business owner and heirs.

### **“AB” Trust**

The simple trust above is what is called an “AB” trust. If the \$3,500,000 left to the surviving spouse were put in a trust, that would be the “A” trust. The surviving spouse could retain control over the assets of the trust or receive annual income from it, with previously assigned beneficiaries to receive the balance at the second death. The “B” trust would contain the \$1,000,000 and could pay income to the spouse, or principal if the A trust is dissipated, until the second death, at which point the two trusts would pass to the children or beneficiaries.

**Living or “Revocable” Trust:** A living or revocable trust can avoid probate costs and provide confidentiality not associated with filing a will. A revocable trust can be managed and revoked by the grantor at any time, except in times of incompetence, and remains part of the grantor's estate. Therefore, there are no estate tax advantages in the establishment of a living trust. However it can provide creditor protection for the quick transfer of assets to the beneficiaries and can avoid some additional costs of estate settlement.

### **“QTIP” Trust**

Qualified terminable interest trusts (QTIP Trusts) are created on the death of the first spouse and provide a way to use the unlimited marital deduction to insure ongoing income to a spouse. QTIP trusts can also specify how the remaining assets will be distributed upon the death of the surviving spouse. This tool prevents the widowed spouse from redirecting trust assets to other beneficiaries, if he or she remarries etc.

### **Grantor Retained Annuity Trust (GRAT)**

A Grantor Retained Annuity Trust is used to transfer property between generations. It is an irrevocable trust that can pay the grantor a fixed sum each year for life or a specified period. At the end of that period, the remaining assets in the trust are distributed to the beneficiaries. With a GRAT, a business owner can place assets in the trust, receive income from the trust for life, then pass the remaining assets on to his or her beneficiaries.

### **Charitable Remainder Trust**

A charitable remainder trust (CRT) is a trust typically established to provide ongoing income to the donor, or chosen beneficiaries, for a fixed period of time; and at the end of that time or at the death of the donor, the assets of the trust are donated to a qualified charitable organization. A CRT is

especially popular with donors who own non-liquid, appreciated property such as company stock, since they can donate that property to the CRT without paying any capital gains taxes and can deduct the appreciated value of the assets from current year income taxes. The trust can sell the asset without incurring any capital gains tax and can invest the proceeds in other assets that yield an ongoing income stream that goes to the donor. A CRT helps business owners fulfill charitable objectives while providing income during their lifetimes.

### **Life Insurance Trust**

A life insurance trust can be established to secure necessary cash for estate taxes and settlement costs or buy stock from the estate. After the trust is established, it purchases or is given life insurance on the grantor. The grantor then makes additional gifts of the premiums until death.

- Upon death, the insurance company pays the death benefit to the trust.
- These funds are excluded from the taxable estate and can be used to make loans to the estate or purchase assets from the estate or stock from the company, thus providing funds for the payment of estate taxes and other costs.
  - Income and assets can then be distributed to the beneficiaries according to the plans of the grantor, or stock can be purchased by the company, other shareholders or family members.
  - The benefit of a life insurance trust is that the insurance policy which provides the funds to purchase stock is held outside the estate. Thus the estate has cash to pay taxes and can pay heirs while leaving the stock in a trust from which the company can buy it gradually.

This is a brief summary some different types of trusts often used in estate and succession planning. Your legal counsel can help you explore these and other options more fully.

## **6: Management Buyout**

Management buyouts are an excellent way to maintain a business when there are no other clear successors. A management buyout will keep the company closely held and will likely continue the business in a way that the owner is likely to find appealing.

Management buyouts can be combined with Employee Stock Ownership Plans (ESOPs) to reduce financing costs. A management buyout is usually a combination of a few different strategies. Often, the first step is for the top management team to arrange to purchase some shares from the retiring shareholder. The funds to purchase those shares can come from the business and can be in the form of debt, current cash flow, or pledges of future income. Many of the strategies used for buy-sell agreements can be used to finance a management buyout.

The management team can, as individuals, save cash to purchase stock and provide equity for a leveraged buyout of the business. This personal savings takes place after taxes. The management team will then invest cash to purchase the business and leverage the remaining portion. This leverage can take a variety of forms.

Loans or notes from banks are the most common form of finance tools for a management-led leveraged buyout. The unfortunate consequences include the fact that interest must be paid, and the principal payments must be paid after taxes. This means that the company is likely to pay about \$1.52 of future earnings for every dollar of stock purchased. Of course the company will have to pay interest on the debt as well.

Notes from the seller or an extended payment time can replace the traditional debt terms. How-

ever, again, payments must be made in post-tax dollars, and reasonable interest must be paid. Seller financing will not allow the former owner to diversify his or her investment. He or she will still share in the risk of the business. This may defeat a major reason for the business owner to cash out. Further, it may be especially uncomfortable since the owner is essentially required to give up majority control to satisfy the IRS that this is a sale of equity rather than a dividend.

In both cases, the business owner must pay capital gains taxes on the proceeds of the sale of the stock. Further, it will be important that the business owner substantially reduce his or her interest in the business; otherwise, the IRS may tax the proceeds of the sale as dividends rather than as capital gains.

Another alternative is to couple a management buyout with an Employee Stock Ownership Plan (ESOP). Managers can own stock as individuals and also receive stock through their participation in the ESOP together with other employees.

Borrowing through an Employee Stock Ownership Plan (ESOP) is a method of financing that is growing in popularity. An ESOP is much like other defined contribution pension plans for the employees, like a 401(k). Unlike other defined contribution plans, however, an ESOP is set up primarily to invest in the stock of the employing company and it can borrow money to do so. Once established, the ESOP can borrow the funds to purchase stock from the owner. The benefit for the company is that the principal payments on the ESOP loan are paid from pretax dollars. This is because the payments to the bank are accounted for as contributions to the ESOP pension plan, a pretax expense. While this form of leverage will still require paying interest on the debt, the company will only have to spend one dollar of pretax earnings to pay back a dollar of principal rather than \$1.52 in conventional financing and seller financed debt.

The business owner can also take advantage of the “§1042 rollover.” The §1042 rollover provision allows business owners to defer capital gains taxes on the gain on the sale of their company stock if they reinvest the proceeds of the sale of stock into a diversified portfolio of domestic operating companies. If the owner does not sell the new diversified portfolio, and if it is left to the estate, capital gains taxes can be avoided completely. (See the next section for more information on the §1042 Rollover.)

Management buyouts can meet the desire of the business owner to continue the business. Since the owner hired the management team to help make the company successful, they are likely to be competent successors and are likely to maintain the character of the business.

Inevitably, leveraged buyouts, by management or anyone else, strap the business with substantial debt. This debt may get in the way of other business plans. Future business plans should be taken into consideration when the management group figures out how much leverage the business can afford to take on. If the business is in need of reinvestment for competitiveness reasons, a large amount of debt may not be desirable. In such cases, it may make sense to use other methods for getting stock into the hands of managers. One option may be to set up a trust to hold assets until the company is prepared to purchase them. This will provide an annual income to the retired business owner or spouse.

## **7: Sale to your employees**

Let's look in more detail at selling part or all of the business to your employees. There are two basic methods of doing so. The most common is the Employee Stock Ownership Plan (ESOP). An ESOP is a very flexible, tax-advantaged tool in succession planning. It can be combined with other ownership succession strategies including majority family ownership or a management buyout.

Less common but useful in smaller businesses is the employee-owned cooperative. Both provide the same tax break to the seller: Capital gains taxes can be deferred, often permanently.

Comparing ESOPs and Cooperatives: ESOPs have tax advantages that make them the employee ownership structure of preference in companies that are profitable and employ more than 20-25 employees. A company that sponsors an ESOP may offset taxable income by contributing its stock to the ESOP as tax-deductible contributions to a qualified pension plan.

Companies that are 100% owned through an ESOP and elect S-Corporation tax status can take advantage of a major tax incentive – they pay no corporate income tax. In an S-Corporation, there is no income tax liability at the corporate level, but rather the income tax liability on profits passes directly to the owners at their individual tax rates. Since an ESOP is tax exempt, a 100% ESOP-owned S-Corporation has no income tax liability. The ESOP participants will ultimately pay taxes when they cash out their accounts after they have left the company.

An ESOP is also the preferred choice when employees will acquire less than all of the target company's shares. There are two reasons for this. First, use of an ESOP does not require that the owner give up control of the company, as would be the case with an employee cooperative. Second, experienced professional advisors believe that it is necessary for a cooperative to be committed to acquiring substantially all of the owner's stock in order to achieve the desired tax effects of a §1042 rollover.

Because ESOPs are Federally regulated, trustee, and qualified employee benefit plans, the cost of establishing them (\$40,000 and up) and maintaining them (\$10-20,000 annually) makes them unduly expensive in smaller or less profitable companies. Furthermore, small ESOPs have great difficulty staying in compliance with the law because they try to save money on professional advice. That eventually catches up with them in expensive Department of Labor fines and Plan corrections.

By contrast, employee co-ops are self-governing membership associations in which members elect the board and have direct ownership in the company. Whereas boards of directors in ESOP companies are elected on a one-share, one-vote basis, boards of directors of employee-owned co-ops are elected by the members on a one-person, one-vote basis. Co-ops are no more difficult to establish than other "C" corporations, but their governance, ownership, and tax environment are unique, so they do require specialized accounting and legal advice. They have different and less immediate tax advantages than ESOPs, but they are less expensive to set up and to maintain. They would seem an ideal employee ownership solution in smaller companies, if the employees intend to acquire all (or almost all) of the company's stock.

Then there is the matter of managing liquidity of the company. In a company that sponsors an ESOP, the company can preserve its cash reserves by contributing its stock to the ESOP in lieu of cash contributions. However, the company will be required to repurchase this stock (i.e., make a market for it) as ESOP retirement benefits become payable to employees. Intelligent ESOP plan design can make these repurchase obligations predictable and manageable.

A cooperative can offset its tax liability by distributing its earnings as "patronage refunds" to its member employees. The cooperative can manage its cash and capital by retaining up to 80% of these patronage refunds for reinvestment directly in the cooperative. This member investment is redeemable only when the cooperative's financial condition (in the judgment of its board of directors) permits. Thus, a cooperative may have more control over its financial resources in the long run.

### **Selling to your employees using an Employee Stock Ownership Plan**

An ESOP is a qualified employee retirement plan. It differs from other qualified retirement plans in two ways: (1) It invests primarily in the stock of the employing company, and (2) it can borrow

money. Since it is a qualified plan, company contributions to the ESOP are tax deductible, even when they go to repay the principal borrowed to buy stock in the company.

Because the ESOP can borrow money, it can be a ready market for closely held stock, including minority interests. A controlling owner can sell a minority portion of his or her holdings now, obtaining liquidity but retaining control until selling the controlling interest at some point in the future. As with other forms of leveraged buyouts, it will probably be necessary to provide collateral on the ESOP loan in the form of company assets.

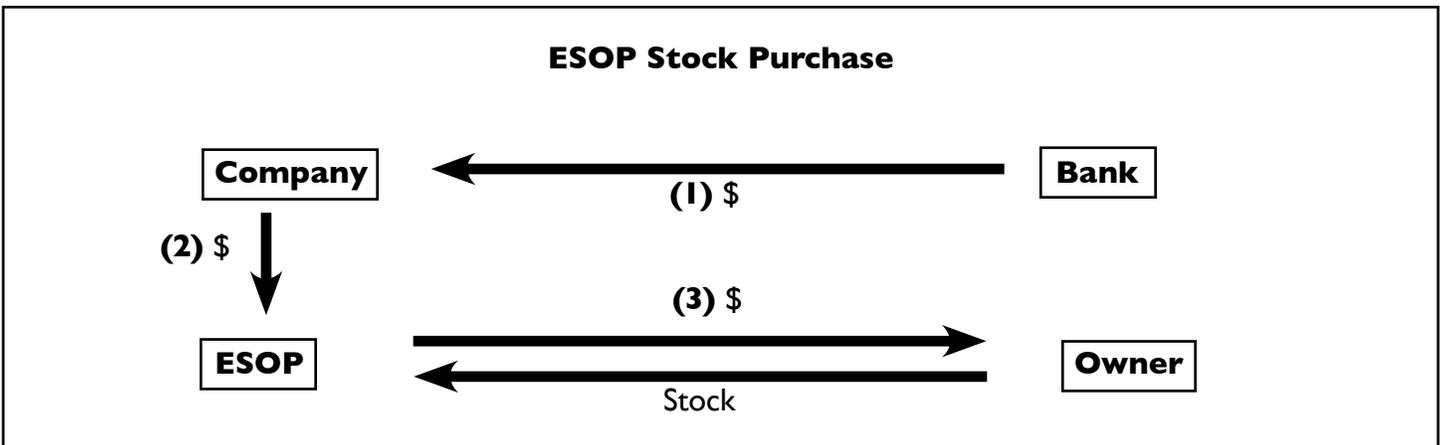
A sale to an ESOP has five main advantages:

- **Fair market value:** The selling shareholder can sell the stock for the fair market price, even when the owner wants to sell a minority interest, perhaps in a long-term staged sale. Minority interests are seldom marketable to other purchasers.
- **Reduced finance cost:** Financing a stock purchase through an ESOP reduces costs because the ESOP can buy the stock with pretax dollars. This means that the company must earn a dollar to buy a dollar of stock, rather than earning \$1.52 to pay \$0.52 in taxes and have a dollar to buy stock.
- **Employee job security:** The ESOP can help to make employees feel secure through the difficult transition of leadership. Since the employees will share in the future success of the business, they are motivated to help the transition go smoothly and make the business successful in the future.
- **Avoid capital gains taxes:** Through a sale to an ESOP the selling shareholder can defer capital gains taxes, and perhaps avoid them all together.
- **Control:** ESOP shares are held in a trust for the employees until they leave the company. The trustee of the ESOP exercises ownership rights over the stock, and the trustee is appointed by the company's board of directors.

Here's how a leveraged ESOP purchase of company stock typically works:

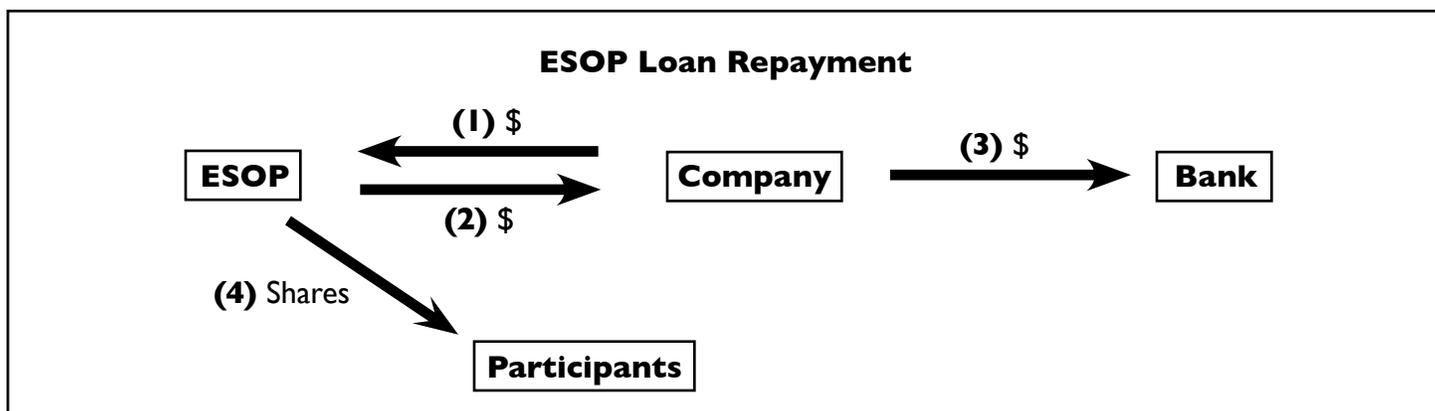
- The ESOP purchase takes place in three stages:

- (1) The company establishes an ESOP and goes to a bank to get a loan for stock acquisition. Company assets are used as collateral.
- (2) The company then makes a "mirror loan" to the ESOP.
- (3) The ESOP uses the loan to purchase the stock from the original owner or his/her beneficiaries. At this point, the ESOP owns the stock, but it is in a suspense account. It has not yet been allocated to any of the individual ESOP participants.



- After the stock is in the ESOP, the loan payments need to be made. These payments are accounted for as contributions to a qualified benefit plan.

- (1) The company makes tax deductible contributions to the ESOP.
- (2) The payments are large enough to pay the principal and interest on the mirror loan. The ESOP uses the contribution to repay the company for the mirror loan.
- (3) The company repays the bank loan.
- (4) As the mirror loan is repaid, shares of stocks are allocated into the individual accounts of ESOP participants.



Let us look at these ESOP tax incentives in greater depth. The seller, the company, and the employees all have tax advantages from ESOPs.

**For the seller:** The selling shareholder can take advantage of a tax-free rollover of his or her investment. If, after the sale, the ESOP owns at least 30% of the outstanding stock in the company, and the owner has held the stock for more than three years, he or she can take advantage of the “§1042 rollover.” The §1042 rollover allows the selling shareholder to defer capital gains taxes on the proceeds of the sale, as long as he or she reinvests those proceeds into domestic operating businesses within a 15 month period. In this way, a sale to the employees often provides the best after-tax price to the seller. Here is how the tax computation works:

Example: Fred initially invested \$100,000 in his company and now has stock worth \$2,100,000. If Fred sold it to someone else, he would have a taxable capital gain of \$2,000,000 (current value minus the original investment). Assuming a federal capital gains tax rate of 15%, Fred’s capital gains tax on this amount will be \$300,000, leaving him \$1,700,000 to spend or invest. If Fred sells the same stock to his employees through an ESOP, and he invests the proceeds in domestic operating companies, the capital gains tax is deferred until he sells the replacement securities. In this way, Fred is able to invest the full \$2,000,000, rather than the after-tax \$1,700,000. If Fred does not sell the new investments, he will never pay capital gains taxes. When the stock passes to the estate, the basis increases to current value. Thus, the business was sold and capital gains taxes were fully avoided. In this case, Fred has saved \$300,000 in federal taxes on the capital gains. The new investments will be part of Fred’s estate and will be subject to estate taxes, unless other plans have been made.

For the seller to use the §1042 rollover, the following requirements have to be met:

- The stock being sold must be “C” corporation stock, and the stock must be closely held.

- The stock must have been owned by the selling stockholder for at least three years.
- Immediately after the sale, the ESOP must own at least thirty percent (30%) of the total outstanding stock of the company.
- Sale proceeds must be reinvested in “qualified replacement properties” within a 15 month period. This “reinvestment period” begins three months before the date of the sale and ends twelve months after the date of the sale.
- If the replacement property is sold, the seller must pay capital gains taxes on the proceeds. The capital gain on which the tax is calculated will be the original basis for the company stock. In the example above, this means that Fred’s capital gains tax would be based on the current value of the investments. Assuming \$2,500,000 current value minus the original basis of \$100,000, Fred’s capital gain would be \$2,400,000 and the tax at 15% would be \$360,000. If the replacement securities pass into Fred’s estate, the deferred tax liability goes away. His heirs could sell the replacement properties without capital gains tax. Of course, regular estate taxes apply to the rollover securities. (See the addendum in the back pocket of this book for updated tax information.)

The rollover securities can be contributed to various trusts which can provide a range of possibilities for assigning beneficiaries and reducing taxes.

**For the business:** The business is able to repay debt used to acquire stock in the ESOP with pretax dollars. The loan payments take the form of a contribution to the ESOP. Because the ESOP is a qualified retirement plan for the employee, the contribution is a pretax expense. The ESOP then uses the contribution to pay off the loan. This means that the business needs to commit one dollar of pretax earnings to pay for one dollar of debt repayment. In traditional financing, the business must commit \$1.52 of pretax earnings to pay \$0.52 in taxes and have one dollar to repay debt. So, an ESOP reduces your finance costs.

**For the employees:** Since an ESOP is a qualified employee benefit plan, ESOP participants pay no tax on their shares until they cash them out, presumably when they are in a lower tax bracket at retirement.

An ESOP can be combined with continued majority family ownership, with a sale of part of the stock to management, and – more rarely – with sale of part of the stock to an outside investor. The attraction to the outside investor is generally that he or she will subsequently find the ESOP a good, tax-advantaged market for his or her stock.

### **Selling to your employees using an employee cooperative\***

There are situations in which you may want to sell to your employees but find that an Employee Stock Ownership Plan (ESOP) is too expensive or that your employees would prefer direct ownership of the company. There is a less-expensive option: selling to your employees through an employee cooperative.

Selling to employees through a cooperative gets the seller the same tax break using the “§1042 rollover” as an ESOP does. If you sell 30% or more of the stock in a C-corporation to the employees of a qualified worker (employee) cooperative, you may defer the capital gains on the part of the proceeds you roll over into other qualified domestic securities – exactly as with an ESOP. The other rules that apply for a §1042 rollover in an ESOP apply in a co-operative as well.

An employee cooperative is a corporation owned and controlled by its employees that jointly markets the products or services produced by its member-employees in the same way as a farmers’ cooperative markets its members’ production of grain or milk. In most employee cooperatives, each

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\* Thanks to Mark Stewart for his assistance on this section

member-employee has one vote in the affairs of the cooperative. Its profits are allocated among the members on the basis of the value of the labor (“patronage”) each contributes to the co-op. In co-ops, financial ownership is generally separated from voting control and distribution of profits.

Because cooperatives are not qualified employee benefit plans, they are not as highly regulated as ESOPs are. Therefore they are less expensive to put in place and to maintain from year to year. But they have different tax benefits – other than the identical tax benefit to the seller – that may be less attractive than an ESOP. An employee cooperative may pass its income through to its employees from year to year without taxation at the corporate level. However, the employees must include these “patronage refunds” in their gross income for federal tax purposes when they receive a notice of allocation from the cooperative (within 8-1/2 months after the end of the cooperative’s tax year). Thus, the cooperative achieves a tax benefit similar to that available to a company sponsoring an ESOP, but the employees must recognize the income currently, rather than later when they receive pension benefits from the ESOP. (There is, however, no tax when co-op members’ accounts are paid out.) The trade-off for current taxation of amounts received by the employees is that the employees gain current and direct ownership of the cooperative and its profits.

Generally the immediate tax advantages of the ESOP make it preferable in larger companies and in cases where less than 100% of the company’s ownership will eventually be transferred to the employees. The lower costs of setting up co-ops make them preferable in smaller companies. The dividing line for balancing the lower cost of a cooperative vs. the immediate tax benefit of an ESOP is typically about 20 employees.

**Single-stage sale to a cooperative:** If a business owner is able to sell substantially all of his/her shares to the employees in a single transaction, it is simple to do so with a co-op. The employees simply set up a co-op, and buy shares from the owner, or the existing corporation is transformed into a cooperative that redeems all, or substantially all, of the owner’s shares. An ESOP-style fair-market value appraisal should be done in order to justify the purchase price for the employees. The seller may need to guarantee the loan and put up replacement securities as additional collateral for any financing of the purchase.

**Multi-stage sale to a cooperative:** A multi-step sale gets around the problem in financing 100% leveraged transactions. Here the owner sells at least 30% of the company’s stock – the minimum to trigger the §1042 capital gains deferral – to the employees in the first step and sells the remainder to them in one, two, or more additional steps after the initial debt has been paid off. In this case, the existing corporation’s articles of incorporation and bylaws are first changed to provide for co-op ownership. Second, the co-op redeems (purchases) at least 30% of the sellers’ stock with an agreement to purchase the rest of the stock on specific terms in the future. Third, the redeemed stock is re-sold to the employees in the same proportion that they will receive their annual allocations of cooperative earnings. There should be a fair-market valuation at each sale stock to the cooperative.

This model has two distinct financial advantages for the selling owner beyond the §1042 tax deferral. First, there is no need for a “minority discount” (as there is in an ESOP) on the price paid to the owners on the first stock redemption even though it is a minority stake, because a co-op by definition must be controlled by its members. Second, the owner can be a member of the co-op as long as he/she remains employed, and thus the owner can receive patronage allocations from the cooperative’s profits annually. As in an ESOP, an owner cannot receive any of the stock he/she sold.

The selling owner has to be comfortable with a board elected on a one-member, one-vote basis and with the inherently democratic nature of the cooperative (although transitional protections can be built in for the selling owner). Likewise, the employees must be comfortable with accepting the responsibilities of capital ownership and management of the cooperative. The corporate culture of

an employee cooperative should include an atmosphere of mutual trust and support among the employees and a participative style of management.

Unlike ESOPs, which are trusted pension plans and whose trustees act on behalf of the employees' retirement benefit interests to buy the stock, a cooperative and its members act on their own behalf. The members of a cooperative buy the company without any formal legal regulation of the transaction. The formal regulation of an ESOP does not guarantee that the employee's interests will be immune from an unfortunate stock purchase decision, but the transaction is subject to certain objective standards of fairness to the employees. Cooperative members' recourse for a misguided purchase of stock might be against the owner for fraud in the sale of the company, but there may be no fraud, just an absence of pertinent information. So, it is in the interest of both the cooperative and the selling owner that the members are fully informed about the transaction through some sort of offering statement that describes the business, its historical performance, its prospects, the new co-op, the transaction, and its risks.

Whether using an ESOP or a co-op for the sale, the selling owner should use the period of the sale to train employees to run the business successfully.

For more information on selling to your employees, see the OEOC publication *Selling to Your Employees through an ESOP or a Co-op* or visit the library on the OEOC website at [www.kent.edu/oec/OEOCLibrary/](http://www.kent.edu/oec/OEOCLibrary/).

## **8: Sale to an outsider**

Selling a business to an outside party is not traditionally considered "succession planning" because the business often ceases to exist as an independent entity. Often, smaller businesses are sold to "strategic buyers" who integrate it with their business. However, for some business owners, it may be the best way to meet their expectations for their retirement income.

A sale to an outsider is generally a four step process. First the owner must prepare the business to be sold. Much like selling a car or home, this is the process of "cleaning up" to make it look attractive to potential buyers. Second, the owner will need to bring in an advisor for the sale. Third, the business is put on the market and the advisor responds to interested buyers. Finally, when a buyer is found, negotiations take place and a deal is closed.

### **Step 1**

Before most small businesses can be marketed, they need to be "cleaned up." Just as a house or car needs to be "spruced up" to show its strongest features before being put on the market, most small businesses need it too. For the business, it generally requires "cleaning the books." This means making sure the books are clear and consistent from year to year and taking care of any notes or loans to and from the owners or managers. While these are common in small businesses, they must be accounted for clearly in the buyer's package. A prospective buyer will need clear and understandable historical financials for comparison. For a buyer's package, the numbers should be consistent in meaning and presentation. Unusual or extraordinary expenses should be noted and explained.

The broker or accountant will help pull these figures together, but sometimes resolving debts or loans from or to the company will take years. Owners can save time by taking care of these issues in advance.

### **Step 2**

It is important to hire an advisor to help sell the business. Owners generally should not represent themselves in the sale of their businesses. The owner is too emotionally close to the business and the negotiations will have a huge impact on the future of the owner and his or her family. The owner knows how to run the business, but not how to sell it. The process takes time and may be a serious distraction from the work of the

business which, after all, must remain successful if it is to be sold at a reasonable price. These four factors combine to make it extremely important to hire a good advisor. A business broker, investment banker or outside advisor can help insure that the negotiated price and terms are reasonable and the deal is sound financially and legally. Your broker will create a buyer's package. This package will include information on the business, product, market, historical financial performance and perhaps some projections.

### **Step 3**

The broker or investment banker will inform the market that the business is for sale. Generally, they will seek two types of investors: strategic and financial. Strategic investors are often in a similar or related business and will want to integrate your business into their current business. Financial investors, on the other hand, will see the business only as an investment and examine the potential return on the investment. Financial investors will want to see that competent management will remain at the business while strategic investors are more likely to take over active management themselves.

As potential buyers emerge, the broker will field their inquiries, answer their questions, and distribute buyer's packages. These preliminary discussions can be distracting for the business owner; thus, it is important to leave them to the broker or advisor. At this point, though, the owner should know that there are likely to be many more inquiries than serious offers and it may take time for a good buyer to emerge. In the meantime, the business owner must remain focused on the continued success of the business.

### **Step 4**

When a serious buyer emerges, the price and terms of the sale will be negotiated. While an advisor can give a round estimate, the true value of the business will not be clear until a price is agreed upon. Since the broker's fees are generally paid as a percentage of the sale price, they will generally work hard to get a fair price for the owner. Once again, the business owner may be too close to the business to handle these negotiations directly. By refusing to sell to a competitor or strategic investor, the business owner may pass up a potential buyer most likely to pay the highest price.

Negotiations continue until an impasse is reached or the price and terms are agreed upon by the buyer and seller. At that point, the legal documents are signed and the deal is finalized. After this, it is time for the owner to take a break from the business and begin to plan for the next stage of his or her life.

## **9: Liquidation of the Business**

Liquidation of a corporation does not strictly fit into "Succession Planning." There isn't much "succession" when a company simply ceases to exist. In some cases, however, liquidation is, in fact, the best option for the business owner, and therefore we consider it here.

Liquidation value of a business is simply the market value of the assets less liabilities. It is generally lower than the value of the business as an ongoing company.

The process of liquidation begins with an appraisal of the value of the company assets. Next, the liabilities are calculated. Sometimes unrecognized liabilities, particularly environmental, can dramatically reduce the liquidation value of the company. The fear of such an occurrence may blind the business owner to discovering the environmental liabilities and he or she may simply cease operations, sell the assets, and abandon the real estate. Fortunately, the Environmental Protection Agency

has begun working on creative solutions to this problem. However, the abatement of environmental liabilities does take time, and if there is an EPA problem, it will affect the sale of the real estate.

From a tax perspective, liquidation of assets is treated in a manner similar to dividends – double taxation. When assets are sold by the business, the company is taxed at the corporate income tax rate on the difference between the depreciated value of the asset and the sale price. The shareholders must also pay personal capital gains taxes when the proceeds pass from the corporation to the owners, to the extent that they exceed the basis value of the stock. Combined, these taxes could reach 50%.

**For example:** *A corporation has assets with a liquidation value of \$100,000 and with a corporate tax basis of \$20,000 (cost less depreciation). The business will have to pay taxes on the \$80,000 difference. When the proceeds are received by the stockholders at liquidation, they will pay capital gains taxes on the income.\**

Sometimes, keeping the business in existence as a holding company that provides a continued income to the owner makes more sense. In this case, the company remains in existence, but sells its assets, using the proceeds to make investments. What was an operating company becomes a holding company that invests in a diversified portfolio. In this way, the business continues to provide income to the owner through dividends but holds no hard assets. Trusts can be used to shield the double taxation. For example, the stock can be donated to a charitable remainder trust; the trust then provides ongoing income to the business owner at whose death the assets are donated to the charity.

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\* The information in this section is from Stephan Leimberg, Jerry Kasner, Stephan Kandell, Ralph Miller, Morey Rosenbloom, and Herbert Levy, *The Tools and Techniques of Estate Planning* (Cincinnati, OH: NULaw Services, 1995).



## 4. Additional Resources

Aronoff, Craig, Joseph Astrachan, and John Ward. *Family Business Sourcebook II* (Marietta, GA: Business Owner Resources, 1996), 740 pages. This comprehensive reference book includes articles from many leading family business advisors on a broad range of topics important to family businesses. Articles from advisors and business owners are organized into 17 topic areas ranging from succession planning to family conflict resolution.

Aronoff, Craig E., Stephen L. McClure, and John L. Ward. *Family Business Succession: The Final Test of Greatness*, Second Edition (Marietta Ga: Business Owner Resources, 2003) 74 pages. A short and readable introduction to the issues.

Cady, Donald. *2007 Field Guide to Estate Planning, Business Planning, & Employee Benefits* (Cincinnati, OH: National Underwriter, 2007), 612 pages. This guide is designed primarily for service providers. Therefore it is somewhat technical in presentation, but includes a number of excellent illustrations. It is an especially good resource for business owners who want to explore the alternatives more fully.

Cohn, Mike. *Passing The Torch: Succession Retirement, and Estate Planning in Family Owned Businesses* (New York: McGraw-Hill, 1992), 290 pages. This is an excellent resource for business owners as they begin planning for succession. It is quite readable and provides solid explanations and charts of complex concepts. For business owners willing to take a little more time to learn about the process they are beginning, *Passing the Torch* should be the first book they read.

Engel, Peter. *What's Your Exit Strategy?: 7 Ways to Maximize the Value of the Business You've Built* (Rocklin, Ca: Prima Publishing, 1999), 242 pages. An easy-to-read book with lots of good examples.

Leimberg, Stephan, Morey Rosenbloom, and Joseph Yohlin. *The Corporate Buy-Sell Handbook: An Essential Guide to Business Succession Planning* (Chicago: Dearborn Financial Publishing, 1992), 330 pages. This book provides a complete and detailed explanation of the many uses of buy-sell agreements and is designed, in part, for practitioners.

Leimberg, Stephan, Jerry Kasner, Stephen Kandell, Ralph Miller, and Morey Rosenbloom. *The Tools & Techniques of Estate Planning, 14th Edition* (National Underwriter Company, 2006), 716 pages. This is an exhaustive guide to estate planning, and is also an excellent resource for succession planning.



# 5. Worksheets

## Worksheet 1: Identify Your Goals

This worksheet is designed to help you begin exploring your personal goals for succession planning. Each topic should be explored more carefully, but briefly identifying each will help frame your plan. Take a few minutes to summarize your personal goals. Later, take each topic and write down your personal goals in each category.

Future income (see worksheets 2 and 3). What income do you need for a secure retirement?

Involvement in the business. How much continuing involvement do you want? For how long?

Investment. Do you want to cash out immediately, maintain an equity stake, cash out over some years?

Legacy. How do you want to leave the business & how do you want it to continue?

Values. What personal values impact your succession choices?

## Worksheet 2: Define Your Current Income

This worksheet will help you define your current income. Once it is clearly defined, it is easier to make adjustments and identify your desired retirement income.

What is your current cash compensation? \$ \_\_\_\_\_ A

What is the cost of your additional benefits:

Medical insurance: \_\_\_\_\_ B

Dental insurance: \_\_\_\_\_ C

Other benefits:

Company car:

Maintenance: \_\_\_\_\_ D

Insurance: \_\_\_\_\_ E

Travel expenses: \_\_\_\_\_ F

Memberships:

Recreational clubs & greens fees: \_\_\_\_\_ G

Professional organizations: \_\_\_\_\_ H

Subscriptions:

Professional journals: \_\_\_\_\_ I

Newspapers & magazines: \_\_\_\_\_ J

Other:

\_\_\_\_\_ : \_\_\_\_\_ K

\_\_\_\_\_ : \_\_\_\_\_ L

\_\_\_\_\_ : \_\_\_\_\_ M

Total current compensation (total lines A through M): \$ \_\_\_\_\_ N

This worksheet should give a reasonable estimate of your current income from the business. Based upon this income level, you can make adjustments (Worksheet 3), project the level of income expected in retirement to maintain your current standard of living and your level of dependence on the business for that income. Some advisors assume that the owner will need 70% of their current income in retirement to maintain their standard of living.

### Worksheet 3: Define Your Dependence on the Business for Future Income

This worksheet will help you define your expected future income. Once it is clearly defined, it is easier to identify your dependence on the business for that income and desired retirement income.

What is your total current compensation? (Line N from worksheet 2) \$ \_\_\_\_\_A

Adjustments to expenses: (At retirement, some expenses increase while others decrease. It is important to consider these changes and estimate their impact on the owner's future income.)

    Changes in auto expenses (increased or decreased usage): \_\_\_\_\_B

    Changes in club membership expenses and greens fees: \_\_\_\_\_C

    Changes in travel expenses (decreased professional travel): \_\_\_\_\_D

        Increased personal travel: \_\_\_\_\_E

    Reduced professional organization memberships: \_\_\_\_\_F

    Subscriptions:

        Professional journals newspapers and magazines: \_\_\_\_\_G

    Reduced clothing and dry cleaning expenses: \_\_\_\_\_H

    Other:

        \_\_\_\_\_I \_\_\_\_\_I

        \_\_\_\_\_J \_\_\_\_\_J

        \_\_\_\_\_K \_\_\_\_\_K

Total desired future income (total lines A through K): \_\_\_\_\_L

Expected annual future income from other sources:

    401(k): \_\_\_\_\_M

    Other retirement plans: \_\_\_\_\_N

    Social Security (available from SS information line.) \_\_\_\_\_O

    Other investments: \_\_\_\_\_P

Total expected annual future income from other sources: \_\_\_\_\_Q

Annual income desired from the business (line L minus Q): \$\_\_\_\_\_R

Remember, this is an annual figure, it can include direct income from the business, special retirement packages, or income from proceeds reinvested after the sale of the business and ongoing income from serving on the Board of Directors or as a special consultant to the business.

## Worksheet 4: Identify Needs and Goals of Other Stakeholders

Who are the other stakeholders?

Family --

Partners --

Managers --

Employees --

Others --

What are their needs?

Family --

Partners --

Managers --

Employees --

Others --

What are their goals?

Family --

Partners --

Managers --

Employees --

Others --

## **Worksheet 5: Management Succession Planning**

What are your top five most important current roles in the business?

- 1.
- 2.
- 3.
- 4.
- 5.

How will each of these be covered when you retire?

Assess the skills and abilities of your potential successor & management team.

What are the plans/hopes of your potential successor & management team?

What incentives are needed to keep managers on board?

## Worksheet 6: “Best Case Scenario”

Summarize your needs & goals:

Income:

Investment:

Involvement:

Legacy:

Values:

Summarize the needs and goals of others involved:

Family:

Managers:

Other owners:

What is necessary to ensure smooth management succession?

1.

2.

3.

How long will this process take:

## **Worksheet 7: Design a Unified Set of Goals for Your “Best Case Scenario”**

Your desired annual income or cash out value:

Ownership transition:

To whom:

Time frame:

Management transition:

To whom:

Time frame:

What continuing involvement in the business do you desire:

Personal goals:

Income to spouse:

Income to other family members:

Charitable goals:

## Worksheet 8: Estimate of Federal Estate Taxes

Following is a brief worksheet to help estimate the federal taxes due on your estate. This is only an estimate. For the sake of simplicity, many calculations have been left out; therefore, it should not be used for formal succession planning.

		Approx. Value
Personal property - Liquid assets: (Cash, mutual funds, CDs, bonds etc.):		\$_____ A
- Automobile(s):		_____ B
- Jewelry:		_____ C
- Accessories: (Sport and activity equipment, art, collections):		_____ D
Real Estate - Home:		_____ E
- Other home (s):		_____ F
- Business/rental:		_____ G
- Other:		_____ H
Life insurance - Value of death benefit to estate:		_____ I
Retirement benefits - 401(k):		_____ J
- IRA:		_____ K
Total approximate value of assets:	Sum A through K:	_____ L
Debts - Mortgage(s) on home (s):		_____ M
- Auto loans:		_____ N
- Other loans:		_____ O
Total approximate liabilities:	Sum N through O:	_____ P
Approximate value of taxable estate:	L minus P:	_____ Q
Estate tax on line Q. (Use the table in the Addendum in the back pocket to calculate the amount of estate tax)		_____ R
Amount of applicable tax credit (see Addendum):		_____ S
Approximate estate tax due		\$_____ T
Subtract line S from line R (usually due in 9 months, in cash)		

## Worksheet 9: Estimate of State of Ohio Estate Taxes

Following is a brief worksheet to help estimate the Ohio taxes due on your estate. This is only an estimate. For the sake of simplicity, many calculations have been left out and it should not be used for formal succession planning.

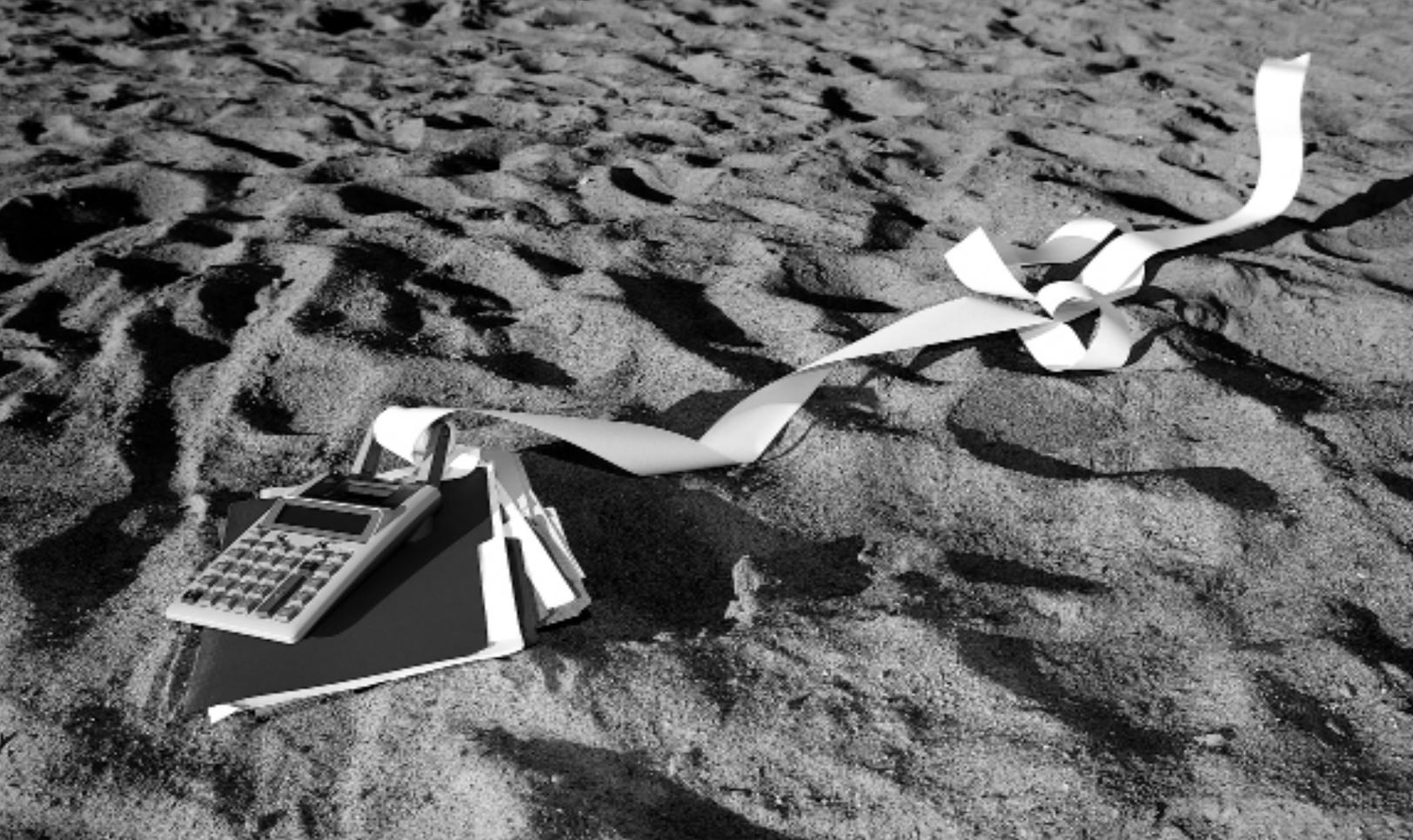
	Approx. Value
Personal property - Liquid assets: (Cash, mutual funds, CDs, bonds etc.)	\$_____ A
- Automobile(s):	_____ B
- Jewelry:	_____ C
- Accessories: (Sport and activity equipment, art, collections)	_____ D
Real Estate located in Ohio: - Home:	_____ E
- Other home (s):	_____ F
- Business/rental:	_____ G
- Other:	_____ H
Life insurance - Value of death benefit:	_____ I
Retirement benefits - 401(k):	_____ J
- IRA:	_____ K
Total approximate value of assets: Sum A through K:	_____ L
Debts - Mortgage(s) on home (s):	_____ M
- Auto loans:	_____ N
- Other loans:	_____ O
Total approximate liabilities: Sum M through O:	_____ P
Approximate value of taxable estate: L minus P:	_____ Q
State of Ohio Estate Tax on line R. Use the table in the Addendum:	_____ R
Amount of Ohio applicable tax credit (see Addendum)	_____ S
Approximate state tax due:	_____ T
Approximate federal tax due:	_____ U
Total estate taxes due (line T plus line U):	_____ V
Total estate value (line Q above):	_____ W
Estate remaining for heirs (line W minus line V):	\$_____ X

What's included with this book:

- Current tax information
- DVD with "Business Succession Planning" video

Video includes the following segments:

- Business Succession Planning
  - 1) An Introduction to Succession Planning
  - 2) Family Issues
  - 3) Valuation
  - 4) Management Succession
  - 5) Trusts & Insurance
  - 6) Selling to an Outside Buyer
  - 7) Selling to Your Employees
- Owners Speak: Three companies share their experiences



AN OWNER'S GUIDE TO BUSINESS SUCCESSION PLANNING is a basic roadmap to assist owners of small and medium-sized business as they begin to plan for ownership and management succession. Inside you will find:

- A simple six-step process that will help business owners plan for succession. The process is designed to insure that it is the owner's goals that shape succession planning tools like insurance and trusts, not the other way around.
- An overview of the more common strategies and tools from which you may select to implement your succession plan

The book also includes resources for your own planning, suggested readings, worksheets to help you through the process, and a succession planning video on an enclosed dvd.