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Succession Planning for the Successful Family Business in 2020

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This article discusses the family business succession planning process and the changes we can expect to see in the remaining months of 2020, including the impacts of COVID-19 and the November elections.

Business succession planning, complicated even in a predictable year, is a two-pronged process.

First, we must deal with intra-family issues and oftentimes we add the role of psychologist to our tax and estate planning capacity. It is likely that any intra-family issues have been aggravated by the additional stress of 2020 as a result of quarantine orders, business shutdowns, and unemployment. Business owners may suddenly find themselves with family members that are unexpectedly unemployed and rely upon the family business as a source of employment. Furthermore, some have suggested we will see a surge of divorces as family courts begin to reopen and face a flood of quarantine-induced disputes, meaning all business—but especially family-owned business—should be revisiting their operating agreements and shareholder restrictions, lest they find the unfriendly ex-spouse of a shareholder is suddenly an unwitting business partner.

Then, if we can resolve these intra-family issues, we can implement a series of legal and tax-driven methods or techniques to satisfy the family's objectives which will maximize the business's long-term success and minimize tax consequences of inter-generational transfers in concert with family members' estate plans.

IMPORTANCE OF AND BARRIERS TO FAMILY-OWNED BUSINESSES

Our economy relies heavily on the success and preservation of family-owned businesses. Ninety percent of all businesses in the United States are family controlled. They produce over 64% of the nation's gross domestic product, generate 62% of the nation's employment, and account for 78% of all new job creation.[1] Therefore, the continued vitality of these businesses has a profound impact on the United States economy, including employment. However, only one-third of these businesses survive the second generation, 12% survive the third generation, and merely three percent make it to the fourth generation and beyond.

One of the greatest barriers to even starting a family-run business is the perceived immortality of the founder. Founders often believe they will always be around to either run the business or to give guidance to the next generation. Combined with a reluctance to relinquish power and perhaps a reluctance to trigger sibling rivalries by not addressing the relative competence of the family members who may be active or might become active in the family business. The hesitance to transition control to the next generation may hamstring an otherwise successful company. Although inheritance taxes are also a threat to survival of the family business, the focal point of succession planning is not estate and tax planning but rather complex family issues and the emotional fall out that results.

When Connecticut went into lockdown in early 2020 as a result of COVID-19, many businesses got a preview of this potential issue. Longstanding company owners, tending to be in a higher-risk age group, suddenly found themselves unable to go to the office and conduct business in person, as they had done every day for decades before. In their place, more tech-savvy members of management were called upon to maintain communication and operations in a remote space. With business events transitioning from long dinners and in-person board meetings, to zoom calls and lengthy e-mail strings, many members of senior management found themselves uncomfortable with the new format—and missing the social interactions that had kept them in the office past retirement age in the first place. Now that it remains unclear when business can return to normal, several business owners have found themselves wanting to take a step back. In other cases, the next generation that stepped in to keep the business running during the crisis is starting to demand that the transition take place sooner rather than later.

The pandemic also forced many founders to confront their mortality and reconsider the pitfalls of their gerontocracy. For example, if a founder dies unexpectedly and the majority of their wealth is locked in company stock, the estate may need to enter into a forced sale which jeopardizes not only share price but control, continuity, and spousal support.

Not to further complicate the situation, but the impending presidential election has also caused families to re-evaluate their estate plans and, in some cases, spurred a flurry of transactions and transitions to take advantage of current estate exemptions, lower estate rate rates, and the current step-up in basis at death. It is possible—that the landscape of estate planning and the tax consequences of business transitions as we know it will be upended in 2021.

OVERALL APPROACH TO FAMILY BUSINESS SUCCESSION PLANNING

Ultimately, the next generation cannot force a business transition faster than the founder or current controlling generation is willing to move. Most often, the controlling generation begins by transferring control, but not ownership, while maintaining an advisory role. For example, by maintaining the role as the chairman of the board of directors and the controlling shareholder, the founder may allow the next generation to take over all day-to-day decision-making, with the gentle threat of removal should the next generation run amok with the business.

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We have found that the transition from founder to next generation is the hardest of any transitions—the further removed from the founder, the less family politics plays into business decisions. In order to transition control and ownership away from the founder, however, we must carefully blend family and business priorities. The considerations are as follows:

1. Who will run the business day-to-day? How can authority be divided—if at all—among decision-makers in order to maximize profitability and align interests with the success of the business?
2. What tax and business strategies can we adopt to minimize the friction of transition and maximize value?
3. How can we reduce transfer taxes and, if necessary, provide liquidity for the founder's estate to avoid a forced sale at the founder's death?
4. How can be fund adequate post-retirement income to the founder and their spouse?
5. How can non-family key employees be rewarded and incentivized to stay on board?
6. What is the ultimate goal for the business? Should the business be sold instead of transitioned? Will private equity or other funding be required to cash out the founder or take some money off the table while maintaining adequate working capital? Does the founder want the family to maintain ownership of the enterprise indefinitely? Does the next generation agree?

One size does not fit all in the succession planning process. Every family's objectives will be different and it is our job to assist the family in achieving those objectives in a tax-efficient manner, and, when necessary, to give firm guidance when it becomes apparent that the founder is heading down the wrong path.

SUCCESSFUL NON-ECONOMIC PLANNING STRATEGIES

We have found several successful succession planning strategies. These strategies are described below, along with how the current atmosphere might encourage or discourage their use in 2020.

1. *Assemble a Trusted Advisory Panel*

All too often, founders are unwilling to share the details of transitions and consult other stakeholders in the process. In our experience, clients that assemble an informal advisory board consisting of family members, the family lawyer or a specialist in this area, the company's accountants and perhaps even knowledgeable and sophisticated family friends, are better positioned to design a succession plan that is tax efficient, sensitive to family values, and well-received by all stakeholders. Not only can this advisory panel provide valuable input, it can provide a mechanism for deflecting family controversy away from the patriarch or matriarch in the event sibling rivalries do arise. In this strategy, independent advisors can become key. *2. Start Early*

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The succession planning process should start early. Families that wait until severe illness arises risk deflated value, knowledge loss, and the kind of mistakes that occur in an overnight rush to get documents signed at a bedside. Starting the process while the next generation is still young provides opportunities to train them to assume the appropriate positions and to perform the appropriate functions in the business while the founder is still around to provide guidance. By observing the next generation in these roles over the course of several years, it may become apparent that the eldest sibling, for example, is better suited for a non-managerial role and the youngest sibling has demonstrated a unique aptitude for management. If the transitioning process starts early, the next generation can grow into their positions while their mentor is still available for consultation and guidance.

3. Treat Children Fairly, Not Equally

It is an often-repeated mistake that all children are treated equally in order to preserve family relations. However, dividing a business equally among the next generation more often leads to resentment from those siblings more active in the company and creates a high potential for deadlock.

One way to treat children fairly without necessarily treating them equally is to divide the business among those active in it and give other children non-business assets of comparable value. In the alternative, you can give those active in the business voting interests, while those not active non-voting interests. The decision whether the non-active siblings should be receiving non-voting interests or no interest whatsoever is a difficult one and is going to be based upon family dynamics, restrictions on transfer and control, and whether other assets exist that can be transferred to the non-active siblings. Clearly, most children who are active in the business do not want to share the results of their efforts with those who are inactive, and they certainly will not want to share control.

Another option to settle feuding siblings might be to divide the business by business segments or business geographical locations. Similarly, a new entity may be formed to exploit a new business development or opportunity, particularly where there is excellent growth potential. These techniques create opportunities or solutions when it is necessary for siblings to go their separate ways. Each child can exploit their own business if that is preferred to working together in a unitary business, or if a sibling's entry into the existing business is resisted by siblings who do not want to suffer dilution of the value those siblings worked to build.

4. Create a Meritocracy

The advisory board should work with the founder to create a meritocracy that demands competency and high-quality job performance rather than relying on bloodlines for success. This is a fundamental shift in the usual family paradigm. The founder should start this process by evaluating each child's particular strengths and use those to define their role in the company. An obviously example is a child who is an accounting major should not be employed in the marketing side of the business, but rather should be a candidate for the controller or CFO job. If there are siblings that have no interest in the business or are not capable of managing (or even participating in) the business, then the founder should take steps to reduce or eliminate their interest in the family business.

In order to create and maintain a meritocracy, the business needs to retain key employees. Almost every family business is highly dependent upon non-family member key employees who contribute substantially and who will continue to do so after the second generation takes over the business. Founders may also find the next generation takes direction better from non-family employees and can leverage those relationships in the transition process. Of course, employment contracts are the primary method of giving key employees comfort and according them the security necessary to assure their continued loyalty.

A phantom stock plan or stock appreciation rights plan (SAR) allows employees to benefit when the business is sold, thereby rewarding them for their efforts in working with the family to enhance the value of the business. These plans, however, do not transfer any actual ownership interest in the entity to the key employees, thus preserving ownership for the family. These plans might also be used to transfer value to siblings that are not active in the business, if, that is, the active siblings are willing to share the largesse brought about by their efforts and those of the key employees. Importantly, if done right, the implementation of these plans will not result in any income to the employee at the time of the grant of the right.

SUCCESSFUL ECONOMIC PLANNING STRATEGIES

Once the non-economic issues have been surmounted, the founder needs to address the tax and other economic implications of their succession plan. The primary driving factors for determining which tools to use to implement the succession plan are (1) the need for liquidity (either for the founder, the business, or both), and (2) the minimization of transfer taxes.

1. *Provide for Liquidity*

Is the founder in need of cash for retirement or spousal support? If so, then the creation of liquidity should take place during the founder’s life rather than upon their death. One option, of course, is to sell the business during the founder’s lifetime and allow the entire family to cash out. A less extreme option is a recapitalization which results in the sale of a significant interest in the business and gives the family the opportunity to take *some* money off the table. The founder may also use retirement plans to provide liquidity. For example, the founder may sell a portion or all of their stock to an Employee Stock Ownership Plan (“ESOP”) which invests primarily in the company itself. If a founder sells stock in their C corporation[2] to an ESOP and, after the sale, the ESOP owns at least thirty percent (30%) of the company, then the founder can defer the income tax on the gain on the sale by reinvesting the cash received in securities of United States operating companies. The deferral continues so long as the founder holds the replacement securities. If the replacement securities are held until the death of the founder, then the gain realized by the founder on the sale of the shares to the ESOP is never taxed.[3]

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If the founder does not need liquidity during their lifetime, then another way of creating liquidity is to provide for life insurance payable to their spouse or children. This may be a particularly attractive method of compensating children that do not participate in the business.

Another option is to isolate the business real estate from the business to give the founder or certain children the benefit of a consistent income in the form of rental payments. This provides an excellent opportunity by way of rental payments by the business to get cash on an annual basis to the founder (to provide retirement income) or to the inactive children as a method to compensate them for the transfer of the business to the active siblings. If at all possible, real estate should be isolated in a separate entity from the inception of the business, or otherwise as soon as possible, because spinning off real estate will likely incur tax.

Another common option is to have the company redeem the founder’s stock (i.e. buy it back). Under the right circumstances, this is an excellent method of increasing the percentage interests of the active siblings while at the same time extricating cash from the corporation to provide liquidity both to the founder, their spouse, and inactive siblings. If certain tax rules can be met, the cash received by the various family members will be subject to capital gains treatment. The company may also pay the shareholder over time in installments, thereby conserving corporate cash while permitting the selling shareholders to defer recognition of gain while receiving interest income in the meantime.

When determining the need for liquidity, the founder needs to consider all of the non-cash benefits they receive from the company such as health insurance, technology stipends, use of company cars, and other expenses which will become the responsibility of the founder and their spouse. While many of these are manageable, it may be more beneficial to retain some relationship during the founder’s lifetime to allow them to continue certain perks of employment.

A new option for providing liquidity has recently gained in popularity: the use of special purpose acquisition companies, or SPACs. SPACs provide a unique opportunity to take a private entity public, while avoiding a costly and risky initial public offering. SPACs are also known as “blank check” companies because they raise money through an initial public offering themselves, and then seek an appropriate target company and merge with that target, essentially rendering the target a public company all while avoiding the IPO. SPACs should be treated as institutional investors with the added benefit of a public listing. Importantly, most SPACs don’t seek a controlling interest in the target entity, so the founder may be able to secure significant investment without losing their grip on the reins.

2. Minimize Transfer Taxes

When the business constitutes a large part of the founder’s estate, it may be necessary for estate planning purposes that at least some portion of the business interest still held by the founder at their death be either bequeathed outright to the surviving spouse or included in a marital trust to maximize use of the gift and estate tax exemption equivalent of $11,580,000 in 2020 and protect the excess over $11,580,000 from the federal estate tax. By bequeathing the business to the spouse or including it in a marital trust, tax on the transfer of the business is deferred until the spouse's death. This can create a complication, however, if the founder-decedent's objective is to assure that their interest in the business goes to the next generation or only certain children.

If the founder's spouse has been involved in the business and is capable of running it, then an outright bequest might be appropriate. Another option is to put the business interest into the marital trust with trustees that can manage the business. If the marital trust will be holding a controlling interest in the business, then it is important that voting authority be delegated appropriately.

A qualified terminal interest property ("QTIP") trust may be used in order to assure that the stock, particularly voting stock, will ultimately be distributed to the active siblings upon the death of the surviving spouse. This type of trust can be especially helpful where the founder has concerns that the surviving spouse may redirect the stock after the founder dies, i.e. to other family members or in contravention of the succession plan.

Connecticut residents also need to pay particular attention to Connecticut's estate tax regime. Generally, a married couple can pool their gift and estate tax exemption to give away nearly $24 million before there is a *federal* estate tax. However, Connecticut's estate tax exemption of a measly $5.1 million is individual only (it cannot be pooled) and therefore couples may need to re-title assets between them to ensure that the maximize state exemption is used.

POTENTIAL TOOLS

In addition to the techniques described above, there are a few techniques which warrant special discussion because they can be particularly effective or provide unique planning opportunities.

1. *Sale of Stock to Children*

It may seem counterintuitive, but the sale of stock to the next generation rather than gifting of stock can accomplish several goals. Although the sale imposes obligations on the children to make payments to the founding parent and has the undesirable effect of including the value of those payments in the founder's estate, several goals are accomplished:

- The stock is transferred to the children who are active in the business while making cash received upon the sale ultimately available to other siblings.
- The active children now have a financial stake in the success of the business.
- The sale of stock to the children freezes the value of the business as of the date of the sale, thus potentially resulting in a substantially lesser transfer tax to the founder and directly benefitting the children to the

extent of post-sale growth.

Benefits can be amplified by using installments sales to permit the founder to defer payment of the capital gains tax on the sale until the cash is received. Founders may also use self-canceling installment notes or “SCINS” that are cancelled automatically on the death of the founder. If the founder dies before the end of the term, the unrecognized gain on the sale is accelerated, but the unpaid portion of the note is not included in the estate of the seller (the founding parent). Also, no cancellation of indebtedness income is recognized by the child who issued the note upon its cancellation. SCINS have come under recent scrutiny by the IRS, however, so the interest rate will need to reflect the risk premium and should be carefully drafted. 2. *Inter Vivos Gifts of Stock to the Children*

On the other hand, the founder could outright gift stock to the next generation with lifetime gifts. Any gifting plan must be analyzed from the standpoint of the overall estate plan of the founder or transferor, however, and must take into account the transfer taxes that are generated by such a gift. The gifts can be either:

- Outright transfer to family members.
- “Net gifts” that are considered part sale and part gift. In a net gift arrangement, the founder and the recipient agree that the recipient will pay the founder’s gift taxes that become due by reason of the gift. This reduces the amount of the gift by the tax paid on the founder’s behalf and results in the transfer being treated partially as a gift and partially as a sale.

In either case, the value of the gift may be discounted based on, for example, illiquidity and lack of control. This is fairly straight forward, and such gifts may be subject to illiquidity discounts and minority interest discounts.

Whether a gift should be made at death or “inter vivos” (during the lifetime of the donor) depends greatly on an analysis of the trade-off between the step-up in basis at death and inclusion in the founder’s estate. If the interest is gifted during the founder’s lifetime, the donees take the founder’s basis in the business interest (which is likely very low), but the value of the business is not included in the founder’s estate. If, on the other hand, the founder bequeaths the interest at death, the full value of the interest is included in the founder’s estate, but the beneficiaries get the advantage of a step-up in basis to the value of the interest on the date of the founder’s death. It is very difficult to predict the value of the business whenever the founder dies, and perhaps even harder to predict how much the estate tax exemptions, both state and federal, might be at that time—or whether a step-up in basis to date of death value is even still permitted. Exemption limits and the availability of a step-up in basis are both in flux in light of the upcoming elections.

*3. Use of Intentionally Defective Grantor Trusts (“IDGT”)*Using an IDGT (pronounced “ID-git”) is a spin on the regular technique. An IDGT is a special type of trust where transfers to the trust qualify as completed gifts for gift tax purposes, however, the income of the trust will be reported by the grantor, and the grantor/founder will be paying the tax on that income even though by the terms of the trust the income goes to the next generation. The founder's children, therefore, receive an annual gift (not subject to the gift tax) in an amount equal to the income taxes attributable to the annual income payable to the children.

An IDGT can also be used to affect a sale of the business interest to the next generation over the course of many years. The founder generally does not pay capital gain tax on the sale of the business interest to the trust since for tax purposes only, the founder is deemed to have sold the stock to themselves, yet the founder's children are paying the purchase price (perhaps over a number of years in the case of an installment sale) that gives the founder sufficient liquidity to maintain their lifestyle over a protracted period of time. Use of IDGTs can provide significant benefits, but also require precise drafting and compliance with IRS regulations.

4. Use of Family Limited Partnerships... Maybe

Once a favorite technique of tax planners, the use of family limited liability companies and family limited partnerships have been under constant treasury attack. Those seeking to use these vehicles to transfer business interests—often subject to significant liquidity and lack of control discounts—must now proceed with extreme caution. *5. Use of Buy-Sell Agreements*

If the founder simply cannot get on board with any succession planning, at the very least they could provide for a buy-sell agreement upon their death. A buy-sell agreement provides that upon the death of the founder, their interest in the business will be purchased by the company (or a particular shareholder or third party) for a specific amount (either a set amount or one calculated according to a specific formula). These are most often structured as redemption agreements whereby the corporation would purchase the stock from the founder's estate for either cash or installment obligations, which has the added benefit of providing liquidity for the founder's estate, if needed, to provide cash to make the appropriate bequests to other surviving family members.

The cash used to redeem the stock can come from either the accumulated earnings of the company or life insurance owned by the company—although mistakes about proper ownership and beneficiary designations in these insurance policies is all too common. In the alternative, if the corporation does not have sufficient liquidity to pay cash for the decedent's stock, the corporation can issue installment obligations to the decedent. In any case, the company will need to confirm that the buy-sell agreement complies with all covenants in any lending agreements, as the death of the founder is likely to trigger some significant liabilities. Redemption agreements may also qualify for significant benefits in deferring federal estate taxes under Section 6166 of the Internal Revenue Code, which allows the estate to pay taxes on the business interest over a fifteen (15) year period.

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CONCLUSION

Businesses should be examining all their opportunities for maximizing the value of their business. Most are familiar with some of the business-friendly provisions of the CARES Act, which allows businesses to free up additional cash through bonus depreciation, net operating loss carrybacks, and the suspension of the limitation on net business losses. These opportunities for liquidity, along with the challenges created by the COVID-19 pandemic—sudden imposition of technology, supply chain interruptions, and increasing awareness of our aging workforce—create a unique opportunity for businesses to evaluate their succession plans to take advantage of the current climate.

[1] Statistics provided by the Conway Center for Family Business. https://www.familybusinesscenter.com/resources/family-business-facts/

[2] In the case of an S corporation, LLC, or partnership, no deferral is possible and the seller recognizes a capital gain upon sale of the stock to the ESOP unless the entity converts to a C corporation prior to such sale.

[3] Note, however, that President Biden's tax plan proposes eliminating the step up in basis on death which may significantly reduce the benefit of this option.

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