

SOME STORIES OF SUCCESSFUL SUCCESSION (and some not)

NOTE

This material a shortened version of an outline presented at the Duke University Estate Planning Conference. The full version, with all citations, as well as drafting suggestions for lawyers, can be found at www.trustlawyer.com under “Resources for Professionals.”

It is meant to be an overview of some aspects of succession planning. It is not intended to provide legal or tax advice.

MOVIE OUT-TAKE

Father: “You didn’t want the business?”

Son: “No.”

Father: “Why didn’t you tell me sooner?

I could have sold it to your Uncle
Eddie for twice its value and taken
your mother on a ‘round the world
cruise.”

From the movie: “While You Were Sleeping”

I. WHAT IS “SUCCESSION?”

For purposes of this discussion, “succession” is the transmission of a closely held business, as a going concern, primarily to one or more family members.

- A. Succession by inheritance.** There are various techniques which may allow you to pass your business to the next generation using discounted values for estate tax purposes. The “economic value” of the business to

your family and the value which we use for estate tax purposes is not necessarily the same.

- B. Succession by sale.** If fewer than all of your children will be receiving interests in the business, “equality” may demand that a “fair market value” approach be considered. Please see the “First Story,” at VI A, below.

II. INITIAL ISSUES.

- ▶ Is it a Family Business or a family Business? Which comes first?
- ▶ What is the “culture” of the family and the business?
- ▶ What will be the likely company “politics” in the next generation?
- ▶ Is it important to provide a “business home” for relatives?
- ▶ Is retirement income for you a consideration?
- ▶ Is ongoing support for your spouse important?
- ▶ Family identity in community.
- ▶ Maintaining family harmony.
- ▶ Can you frankly discuss estate planning with your children?
- ▶ Will there be a need for outside management? If so, for how long?
- ▶ Might you benefit from a family business consultant?
- ▶ Is there a (preferably written) succession plan?

III. FACTORS FAVORING SUCCESSION.

- A. Business already in 2d, 3d, etc. generation.** Only 30% of family businesses are able to carry on beyond the founder’s lifetime. For those which do, the odds are even worse. Of businesses which are successfully passed down one generation, only 14% remain viable at the “grandchild” level
- B.** Are one or more **children or in-laws, active in the business?**
- C.** If more than one child or in-law is active in business, is there **harmony**

among prospective owners?

- D. **Outlook favorable for business?** Would you invest in the business today?

IV. FACTORS FAVORING ALTERNATIVES.

- A. **No "heir apparent"** or serious conflicts among probable successors. Would it be useful to explore a sale to employees or competitors.
- B. **Founder too much of a "key man."** Is the business, in fact, the founder, personally, so that it will "die with him"?
- C. **Outlook not "rosy" for business or product.** Consider sale of assets or stock.

V. FACTORS INFLUENCING "SHAPE" OF SUCCESSION PLAN.

- A. Older generation's need for cash.
- B. Whether all or fewer than all "heirs" will be active owners.
- C. Estate tax considerations.

VI. FOUR EXAMPLES OF SUCCESSFUL SUCCESSION.

- A. **The Heir Apparent**

FACTS: Phil Battenberg started a manufacturing business in 1953. Phil and his wife, Betty, had four children: Chuck, Annie, Andy and Eddie. Each of the children was offered an opportunity to work in the business. Andy became a sheep

rancher in New Zealand. The two “girls” had no interest in manufacturing. Chuck worked in the business since he graduated from high school. He had passed up opportunities for more lucrative work to stay with his father. Chuck is married and has two sons, Billy and Hal. Billy works in the business. Hal is pursuing other goals.

When we first met, Phil and Betty said that they wanted to treat their children “equally.” They also wanted Chuck to have the business. The business was worth \$2 Million. They had other assets worth \$2.5 Million.

Obviously, if Chuck received the business and the others divided \$2.5 Million, the children would not have been treated “equally.”

DISCUSSION: What is “equality?” Most people initially speak of treating their children equally. Sometimes, after thinking it through, they realize that equality may not be equity. Chuck had worked in the business all his adult life for substantially less than he would have received in the outside world. In the 5-8 years prior to my beginning to work with his parents, he had virtually run it. Nevertheless, his father had consistently held on to the reins of power. After several meetings, Phil and Betty realized that giving Chuck the business and leaving their other assets to Annie, Andy and Eddie would be equitable. True “equality” would be inequitable.

This is a “happy family.” Annie, Andy and Eddie understood and appreciated the contribution which Chuck had made to the family and the business.

WHAT WE DID:

1. Maximizing annual exclusions.

Gifts of up to \$13,000 per year per donee [\$10,000 when I was working with Phil and Betty] reduce the donor’s potentially taxable estate. These “annual exclusion gifts” do

not count against your estate tax exemption. We provided for Phil and Betty to use their annual exclusions creatively.

Phil created an irrevocable trust funded with stock in the business. If Chuck survived Phil, then the stock would pass to him. If he did not, then it would pass to his son, Billy. During the term of the trust, Chuck, his three siblings and nine of Phil's and Betty's grandchildren were potential beneficiaries. Each beneficiary could withdraw his or proportionate share of each annual contribution to the trust. We claimed thirteen annual exclusions on the gift tax returns. Because these were gifts of discountable minority interests, each \$10,000 exclusion let us transfer \$13,000 of real value. That's \$460,000 of value removed from Phil's and Betty's taxable estates each year. This proved to be an excellent opportunity to use discounts to "leverage" annual exclusions.

When we did this, it was an aggressive technique. Since then, several Federal courts have "blessed" it. However, the IRS does not agree with those courts' decisions and may continue to challenge it. This type of trust has to be drafted and administered carefully.

Phil eventually used the balance of his estate and gift tax exemption to pass the remaining stock in the business to Chuck at a discount from its fair market value.

2. Paying estate taxes on non-active children's shares.

Phil wanted Chuck to have the business free of estate taxes. Obviously, the estate taxes would then have to be paid by the other children. We created an irrevocable life insurance trust with a \$1.5 Million policy. The beneficiaries were Andy, Annie and Eddie. The proceeds would be available to pay estate taxes so that all of the non-business assets passed "tax free."

PLANNING POINTS:

- 1. Equality is not always equity. A better term for what clients call**

“equality” might be “rough justice.”

2. Annual exclusion gifts, especially when combined with discounts for lack of control and marketability are one of the most powerful tools we have.
3. Estate and gift tax exemptions should not be hoarded away. They should be used creatively, to make gifts of assets that can be valued at a discount for estate tax purposes by using value reduction or appreciation shifting techniques.
4. Most importantly, in making this type of plan “work,” is that the family **understand and approve.**

B. The “Regency Trust.

FACTS: Josephine had been managing the family business since her husband, Joe, died. Josephine was (and is) chairman of the board. Her son, Joe II, is president and CEO. If he survives his mother, the business will pass to him.

Joe has two children, Joe III and Peggy Sue, who, when we worked on this, were less than ten years old. Josephine hoped that the business would continue into another generation. She wanted to preserve the opportunity for Joe III and Peggy Sue to take over the business at some future time if Joe, II didn’t survive her.

DISCUSSION: When we speak of “succession,” we normally refer to having the business continue in the family. Successful succession can also be the sale of the business as a going concern for the family’s benefit. We wanted to avoid selling “parts” for “breakup value.” If Joe, II, didn’t survive his mother, we needed to create a flexible way to professionally manage the business while Joe III and Peggy Sue were growing up, giving them the opportunity to take it over at an appropriate time. At the same time, the door had to be open to sell the business if it was in the family’s best interests.

WHAT WE DID: If Joe, II does not survive his mother, the stock passes to a trust for Joe III and Peggy Sue. The trustee was given broad powers, including the power to sell. The stock will be distributed to Joe, III and Peggy Sue at a specified age -- provided that they are working in the business and, in the trustee's opinion, are mature enough to manage it. The actual trust language is in the "professional" edition of this outline.

C. Keep Them Working.

FACTS: Barry created a low-carb protein drink called "Barry's Banana Blast." His wife, Mary, is not involved in the business. It's managed by Barry's son, Harry and two long term non-family employees, Bill and Garry. Harry, Bill and Garry are key to its continued success.

DISCUSSION: Barry's primary objective was to keep the business operating with its current management team. If they aren't running the business, he wanted it to be managed co-operatively by its employees. He did not want the stock to pass outright to Mary, Harry, Bill and Garry because they could sell the business. Barry did not want the business to be sold, if at all possible. He wanted it to eventually pass to the employees. If the business were sold, then a portion of the sale proceeds should pass to Barry's favorite charity.

WHAT WE DID: We created separate trusts for each beneficiary. If any beneficiary does not survive Barry, then his or her share will be re-allocated among the others' trusts. The three managers are the "business trustees," charged with making day to day management decisions. They can't increase their own salaries or sell the business or its assets. Those discretions can only be exercised by an "independent trustee." If none of the managers can serve as a trustee, the independent trustee assumes the functions of the business trustees as well.

No stock in the business may be distributed to the beneficiaries of the

trusts. To provide an incentive for them to remain at their jobs, as long as they are full-time employees of the business, have retired after a reaching a specified age or due to disability, they will receive their proportionate share of the business' profits. If they leave the company for any other reason, they remain as beneficiaries of the trust, but distributions to them will be in the independent trustee's discretion.

If the business is sold, the beneficiaries receive a percentage of the proceeds and the balance passes to charity.

Each of the four trusts will terminate at the death of its beneficiary. The interests in the business will be allocated, pro-rata, among the other trusts. After all of the beneficiaries' lifetimes, all of the stock will be distributed to the then employees of the under a formula which recognizes both their compensation and their years of employment.

The actual trust language is in the "professional" version of this outline.

D. Give it to 'em now.

FACTS: Mr. Lishnis had been the sole proprietor of a business with three semi-integrated divisions. Each division had been managed by one of his sons, Bill, Jim and Tim, but Mr. Lishnis remained in control. Although this arrangement had always worked reasonably well, Mr. Lishnes' health had declined and inter-sibling issues emerged. Bill believed that some of the profits of "his" division were being used to inject capital into the division run by Jim. Jim felt that the divisions should be run "one for all and all for one," as they were when his father was healthy. Sam was not sure whether he wanted to continue running a business at all. Mrs. Lishnis had never taken a business management role. Her primary desire was that, when she and Mr. Lishnis were gone, her sons and grandchildren get along as a family.

DISCUSSION: Mr. Lishnis' will gave each of his sons the option to have "his" division allocated as part of his inheritance. If we had done nothing, there would have been some very difficult issues when Mr. Lishnis died, including what assets "belong" to each division, what the values were and whether his sons still wanted them.

WHAT WE DID: We decided to use a large portion of Mr. and Mrs. Lishnis' gift tax exemptions to give each of their sons the assets which he would eventually inherit. I met with each son separately and asked him to come prepared to discuss what assets he actually wanted. One of the most difficult issues was trying to separate Bill's and Jim's divisions which were, in a sense "Siamese twins." After many meetings, and with the help of the family's CPA, we were able to devise a workable plan. Mr. and Mrs. Lishnis retained sufficient assets to take care of themselves for their entire lifetimes. We obtained fair market values of all of the assets so that each son's share would be equal. Each of Bill and Jim would receive the assets of his division together with the building in which it was located. Sam would get sufficient liquid assets to allow him to retire from work and devote his time to other interests.

The sibling issues, which mainly revolved around control of the businesses, should diminish. The administration of Mr. and Mrs. Lishnis' estates will be much simpler and less expensive. This is a win-win situation for the family.

VII. SUCCESSION BY SALE.

A far more sagacious man than I noted that "one really doesn't know his family until he has divided an inheritance with them." The stories of Cain and Abel and of Joseph and his brothers are as relevant today as when they were 5,000 years ago. After the founder's lifetime, simmering rivalries sometimes come to a rapid boil.

A. Alternatives to Sale.

1. Separation. If the family members who are active in the business can't get along, consider dividing the business along product or geographical lines. NOTE: In order to make a corporate division tax-free, you have to comply with the provisions of the Tax Code and Regulations.

2. Distribution of Other Assets. See Section VI A, above.

B. No Family Members Interested. Consider a buy-out agreement with a competitor or with the owner of a similar business in a different location.

C. Engage an advisor early. If you're thinking of selling your business, you might want to speak with a "mergers and acquisitions" advisor. It's sometimes beneficial to engage an advisory firm some years before the potential sale. They can offer meaningful advice on how to maximize the value of your investment.

D. Funding the Sale.

1. Straight installment sale. An installment sale to a family member will be carefully scrutinized. The IRS may try to re-characterize it as a gift. Even though the formalities of a transaction may have been observed and the "debt" was adequately secured, if there is no real intention of making repayment or enforcing the obligation, these facts are of little significance. The IRS has prevailed in several cases, including one in Connecticut, when the parties didn't treat the deal as a normal business transaction. For example, in one case, the donor structured the payments to equal the annual gift tax exclusion and then forgave each payment as it came due.

2. Self Canceling Installment Note (SCIN).

What is it?

- a.** Sale is for promissory note for a term of years.
- b.** The note provides that, if the seller dies prior to end of term, the buyer's obligation is cancelled...

(1) Because, when the debt is cancelled, the seller's estate is not entitled to any payments, any "balance" should escape estate taxation...

(2) The note must reflect a "premium" to reflect the fact that the seller's estate may not collect the full amount. It must take into account the age and, possibly, the state of health, of the seller and the financial stability of the buyer. The premium can be an increase in the sale price or in the interest rate. It should not be "separately stated."

- c.** **When a SCIN makes sense.** If the founder is "sicker than his age" but not expected to die in the near future, a SCIN or a private annuity,

discussed immediately below, can be an excellent way to pass the business to the next generation.

d. No Retained Interests. The sale should be a complete break with the business. The more that the seller “keeps his hand in,” the more it looks less like a sale and more like a transfer with retained interest. The seller should not retain any economic benefits from the business which a “stranger” in a similar situation would not have.

A detailed discussion of some of the court decisions, as well as suggested language for Skins can be found in the “professional” version of this outline.

3. Private Annuity.

What is it?

a. Sale for a series of unsecured annuity payments over the seller’s, or the seller’s and another’s presumed life expectancy.

b. Income for Ma and Pa. Can be for more than one lifetime. Useful to provide a stream of income for the founder and his or her spouse.

c. Estate Tax Exclusion. Like a SCIN, generally no portion of the property is included in the seller’s gross estate because the annuity obligation terminates with the seller’s death. If the business is incorrectly valued, a portion of the purchase price can be considered a “transfer with retained interest” and included in the donor’s taxable estate. Please see “Necessity for Proper Valuation” at 5 a, below.

d. No Security. Unlike a SCIN, the annuitant (seller) may not retain a security interest in the business. Retention of a security interest could cause all of the gain to be recognized within one year.

e. Do Not Key Annuity to Income. The annuity payments should not “track” the income from the business. A “bootstrap acquisition” may be re-characterized as a “transfer with retained life interest” and included in the seller’s

taxable estate. The annuity should be structured so that, using the appropriate rate of interest under the IRS rules, the value of the transferred asset will be totally exhausted by the annuity payments up the date of the seller's presumed "actuarial death." This is probably the largest difference between a properly structured private annuity and an installment sale or SCIN.

f. Risks.

(1) **Buyer may have insufficient resources** to pay the annuity, could become insolvent or acquire creditors.

(2) **Seller could "live too long."** If the seller keeps ticking, the buyer could take a licking.

4. **Is the Seller's Health a Factor?** In a sense, the worse the seller's health, the better it is to do a SCIN or private annuity transaction. Suppose the seller has an "actuarial" life expectancy of 15 years, but is quite sick and is expected to only live for 2 of 3? If he dies in year 3 of a 15 year transaction, only a portion of the value of the transferred asset has come back into his estate via the note or annuity payments. The balance may be subject to capital gain tax or income tax but the net savings could be substantial because estate tax rates can be substantially higher than income tax rates. NOTE: The Regulations provide that if, at the time of sale, the seller was known to have had a disease and dies within a fairly short time, this deal may not work. This presumption can be overcome, however. I settled an estate where the annuitant-seller died about 9 months from the date of sale. We proved that, at that time, neither he nor his doctor realized that he had the condition from which he died.

5. **Important Issues and SCINS and Private Annuities.**

a. **Necessity for Proper Valuation.** Both a SCIN and a private annuity require that the business be properly valued. To the extent that there is a “bargain sale,” the transaction may be re-characterized as a gift with retained life interest.

b. **No Forgiveness.** The need to structure the transaction in a commercially reasonable manner cannot be overemphasized. Just as in a straight installment sale, the deal could be re-structured unless all of the formalities are observed. The court decisions and some drafting language can be found in the “professional” version of this outline.

Some Comparison of SCINS and Private Annuities.

	SCIN	PRIVATE
ANNUITIES		
Income for Seller source	More geared to “bargain to buyer” than to income stream to seller.	Can provide ongoing of income for the seller and his spouse.
Security allowed.	Seller can retain mortgage or other security.	No security interests
Estate Freezing	Yes	Yes
Basis value annuitant if he lives expectancy	Value of obligation at inception	Generally fair market but may be reduced if dies early or increased beyond life
Interest Deduction buyer.	Interest deductible by buyer	Not deductible by

buyer		More expensive for than SCIN
Actuarial Risk seller	No real actuarial risk. Impetus for SCIN may be more “donative” than economic.	Risk to buyer that will live too long.
Taxation of Gain part of Buyer may seller payments	Gain taxed to seller over term of note.	Gain taxed to seller as annuity payments. realize capital gain, if dies before all made.

VIII. “AND SOME NOT”

Here are two examples of “getting it wrong” – both driven by overactive egos. Both of these sad outcomes could have been avoided.

A. Save the Business. Mess up the Family. Jim Bob was the founder of a successful business. His oldest son, Eggbert was a vice president, Jim Bob insisted on leaving Eggbert 80% of the stock, with the balance going to his number two son, Jim Bob, Jr. Almost immediately upon Jim Bob’s death, Eggbert moved into his father’s office, voted himself his father’s salary and started treating his brother like an employee. He told his mother that all “perks” would immediately stop. The business prospered. The family fell apart.

B. Try to Save the Family. Mess Up Both Business and Family. In the 1980s, when I doing his estate planning, Ajax boasted that he was worth \$3.5 Million. When he died in the late 90s, we settled his estate as insolvent. What went wrong?

Ajax, at the height of his power, was the owner of several machine tool factories. He had three houses. As the machine tool business worsened, he continued to provide employment to almost all of his workers. He paid extraordinary salaries to his children.

The best that we were able to do for Ajax' widow was to buy her a very modest house, calling it a "spouse's support allowance" with the help of a creative Probate judge. She ended up in straitened circumstances at a time when she had once believed that she would be living high and wide.

Like Jim Bob, Ajax' ego got in the way. Although he knew, probably better than anyone, that he should have sold his businesses while they were still viable, he refused to do so. Perhaps he thought it would be a sign of weakness.

X. CONCLUSION.

The first step in succession planning is to take a good look at the business and the family. Should the business continue into the next generation or are there other alternatives would make both business and "family" sense? There then should be a well thought out succession plan. This is not a "cookie cutter" document. It is also a team effort. Consider whether a family business consultant would be helpful.

The succession plan should include a mechanism which will provide cash to the current owner and for "non-active" family members. It should not cause a drain on the business' resources. Family limited partnerships, SCINS, private annuities and other "leveraged" techniques may be useful.

Lastly, the plan should be reviewed periodically. Marriage, divorce, changes in health as well as economic factors could make the best thought out succession plan obsolete.

Think it through. Get it done. Your family and employees will appreciate it.