

**SUCCESSION PLANNING: TRANSFERRING  
A BUSINESS TO THE NEXT GENERATION**

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*This outline should be viewed only as a summary of the law and not as a substitute for tax or legal consultation in a particular case. Your comments and questions are always welcome.*

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## **PART ONE - BACKGROUND**

### **1. OVERVIEW OF SUCCESSION PLANNING**

Fundamental issues:

- The owner's need for continuing cash flow from the business.
- The exposure of the owners' estate to estate tax.

Financial objectives:

- Preserve adequate liquidity during life.
- Maximize the net value of the estate after income and estate taxes and transaction costs.

Note: Keeping the business in the family might not be consistent with these goals, especially if there is little management talent in the next generation.

Other objectives:

- Dying with the most chips.
- Retaining control at all costs.

## 2. OVERVIEW OF ESTATE PLANNING

### 2.1 Estate and Gift Tax

For those subject to it, the estate tax is the tax to beat.

Property passing to a spouse is not subject to estate or gift tax, so for many couples the estate tax is deferred until the second spouse dies.

The gift tax is no longer unified with the estate tax. The lifetime gift tax exclusion is \$1 million per donor, and is not scheduled to increase.

The lifetime exclusion for estate tax is \$1.5 million per person for estates of those who die in 2004. It is scheduled to increase to \$2 million in 2006 and \$3.5 million in 2009. In 2010 the estate tax is scheduled to end, only to be revived in 2011 at the rates in effect in 2001.

Until 2004 the family-owned-business exclusion could, when combined with the lifetime exemption amount, exclude up to \$1.3 million from the estate of a decedent who owned a substantial interest in an active family-owned business. The provision expired in 2004, when the lifetime estate tax exclusion amount for everyone increased to \$1.5 million.

An estate with an aggregate net value of more than \$2 million will face an estate tax rate of 49% in 2004, stepping down to 45% in 2007. In 2010 there is scheduled to be no estate tax, and the maximum gift tax rate will be 35%. After 2010 the 2001 estate tax regime is scheduled to return.

Many observers expect legislation to freeze the rates at the 2004 or 2006 levels, but there can be no certainty about future legislation. The changing rates and the uncertain legislative outlook have made estate planning in the 21<sup>st</sup> century more difficult and more frustrating. Families with substantial assets should continue planning and implementing their plans to minimize the estate tax, even though it is a moving target.

Estate tax is due nine months after date of death.

- Section 6166 installment payment provisions allow payment in installments, but the tax must still be paid. At best, Section 6166 buys time at a favorable interest rate. The business must remain a substantial

portion of the estate to get the full deferral benefit, so a typical buy-out under a buy-sell agreement will make the deferral unavailable, even if the stock is paid in installments. The California transfer tax does not have a corresponding deferral provision.

- Without planning, paying the estate tax can ruin the business.

Owners of successful businesses need estate planning advice to avoid unnecessarily paying estate taxes and probate fees. The **estate planning attorney** is usually a key participant in the succession planning process.

## 2.2 Generation-Skipping Transfer Tax

Another tax at rates tied to the estate tax rates. Families with substantial assets should use intelligently their exclusions GST for gifts to grandchildren or in trusts for children. The GST exclusion amounts are the same as the estate tax exclusion amounts.

## 2.3 Income Tax

Highly appreciated assets generate capital gains on sale. Long-term capital gains and certain dividends are taxed at preferential tax rates.

Note: One reason for “high appreciation” is basis reductions from depreciation and amortization deductions.

If an asset is held until death, there is a “**step-up**” (or “step-down”) to the date of death value for all assets held by the decedent or for both halves of community property.<sup>1</sup>

When an asset is transferred by gift, the donee takes the donor’s basis plus any gift taxes paid. *So a lifetime gift of an asset forfeits a potential step-up in basis at death, retaining potential tax liability on the inherent capital gain.* To minimize this problem, gifts of high-basis property<sup>2</sup> should be

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<sup>1</sup> This rule is scheduled to be repealed in 2010 and to be reinstated in 2011. See section 2.1 (Estate and Gift Tax) above for other scheduled changes to federal estate and gift tax laws.

<sup>2</sup> “High-basis” property is property with a tax basis approximately equal to its fair market value. “Low-basis” property is property with a tax basis much less than its fair market value. Prop-

made while both parents are alive and holding their assets as community property; generally, gifts of low-basis property should be deferred until the after the death of the first parent.

Although not discussed in this outline, property and sales taxes and liability protection are other important issues that frequently arise in succession planning.

Important members of the succession planning team are the **income tax advisor** to the business owners, their **corporate attorney** and the **business banker**. They can help develop a plan that will not create unnecessary income tax or other legal or financial problems. These advisors often have experience in succession planning and can provide other valuable suggestions.

## 2.4 Lifetime Gifts

**Advantage:** Moves appreciating assets out of the parents' estate at current values, rather than at the (presumably higher) date-of-death values used for estate tax purposes.

**What to give:**

- 1) Parents can live without it
- 2) Rapidly appreciating
- 3) High tax basis, ideally (because the donee takes a carryover basis increased by any gift tax paid)
- 4) Subject to gift tax discounts (discussed below)

**Disadvantages:** Might violate an entrepreneurial family culture: "Dad earned it but Junior had it handed to him."

Well-meaning efforts to equalize gifts among heirs can cause long-term family friction.

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erty with a basis that is more than its value should be sold by the parents before the first parent dies, to avoid a *step-down* in basis at death that would prevent them from using the income tax loss generated by the sale.

Lose step-up in basis of assets at death.

Note: Gift must be real gifts, with no unwritten strings attached. The IRS has successfully attacked gifts when the donor acted as if the gift had not been made.

## 2.5 Value Engineering

The objective of value engineering is to reduce the value of assets for estate and gift tax purposes with the least interference with the transferors' plans and flexibility, and without affecting the price that the owner could get for the property.

The courts recognize that if an entity owns a asset worth \$100, the value of a 20% interest in the entity is less than \$20. If a 30% discount applies for lack of control over the entity and another 30% discount applies for the lack of marketability of the interest, it may actually be worth only \$10. Similarly, an 80% interest may be worth \$56 if a 30% discount for lack of marketability applies. However, 100% of the entity is probably worth \$100, less the non-tax costs of distributing the asset from the entity. Thus, if Dad owns 100% of the entity, he can immediately reduce its aggregate value to \$66 (\$10 + \$56) by gifting a 20% interest. The IRS acknowledges that family members should not be grouped together to determine if any of them control the property or entity.

If the value of a 10% interest before discounts is \$1 million and there is a 25% discount for lack of control and a 30% discount for lack of marketability, then the discounts are applied as follows:

### Control

$$\$1,000,000 \times (100\% - 25\%) = \$1,000,000 \times 75\% = \$750,000$$

### Marketability

$$\$750,000 \times (100\% - 30\%) = \$750,000 \times 70\% = \$525,000$$

**Discounted Value = \$525,000<sup>3</sup>**

To use these discounts wisely, an **appraiser** who knows how various types of property are valued for tax purposes (and can defend the valuation in an estate tax audit) is a necessary part of the succession planning team when the family plans to make gifts that must be reported to the IRS. To start the statute of limitations running on a gift, it must be reported to the IRS.

Note: The IRS is hostile to value engineering, but the courts have generally respected the concept.

## 2.6 Life Insurance

Use life insurance:

- To make up the liquidity shortfall,
- To provide capital to maintain a spouse or a family's lifestyle,
- To maximize the GST exclusion, and
- To equalize gifts to heirs.

Before buying life insurance to pay estate taxes:

- 1) Estimate estate tax now and in a few years;
- 2) Consider lifetime gifts to minimize growth of the estate;
- 3) Consider value engineering techniques to reduce the value of lifetime gifts and the value of the taxable estate and to shift value the next generation; and
- 4) Identify sources of ready cash in the estate.

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<sup>3</sup> See page 31 for the outline "**Family Limited Partnerships.**"

The policies should be acquired by the second generation directly or by a *life insurance trust* to remove the proceeds from the taxable estate of the insured.

If the business is to go to one child, life insurance can be used to create a fund of equivalent after-tax value for another child.

Because life insurance is a sophisticated financial product, the **life insurance provider/advisor** is a key participant in most succession plans, helping to calculate the need for insurance, to design the policy and payment arrangement and to match the design with the best available policy, considering price, the policy's sensitivity to future changes in interest and mortality rates, and the reputation and stability of the insurer.

## 2.7 **Probate**

Advantage: Cleans up a messy estate, clarifies rights of creditors and family members.

Disadvantages: Expensive, slow, public court procedure. Can ruin a sole proprietorship.

## 2.8 **Living Trust**

Advantage: Avoids probate. Relatively inexpensive and quick. Private. Avoids need for court appointment of conservator.

Disadvantages: A minor hassle and cost for the owners to prevent a major hassle and cost for the heirs.

Only achieves its purpose to the extent that it is funded.

Procedural protections of Probate Court do not apply unless an interested party invokes them.

### 3. NON-TAX CONSIDERATIONS

#### 3.1 Family Dynamics

*Note:* Below is a very superficial summary of an area that received much study since the early 1980s. There are very good books in this area and very good consultants who have written or read the books and can help implement the lessons.

Family systems vs. business systems:

Family system is caring, nurturing, forgiving, accepting.

Business system is competitive, result-oriented, survival of the fittest.

A family business must resolve these competing systems.

Types of succession:

- Ownership (classic estate planning)

The right to share in the profits of operations and the sale of assets.

- Management

Note that ownership and management can be separated.

The next generation of managers must be hired and must be groomed. For family members who expect a role in the family business, successful early careers outside the family business help to build their confidence and credibility.

The older generation must consider the effect of the management transition on the loyal old guard.

Individual life cycle issues: The first generation will reach an age at which it will become very difficult to effect a change as big as management succession. The second generation reaches an age which the fire in the belly cannot be rekindled, and it is too late for a successful management transfer.

Family business evolution: The business starts as one person or couple's vision and they are the business. Then business begins to professionalize management. Next, the business has professional management which includes some family members. Finally, the business is sold and the family enters the business of jointly managing its wealth with a family office and a family foundation. Not all businesses make it to the second and third stages, and not all families with businesses pass through all four stages.

Abilities and interests of various family members

Relationships of family members to the business:

- Are all members of the family involved in the family business? Or are some involved and others not?
- Has anyone articulated the family's long-term business goals? Is there a general consensus in the family on their long-term business goals?
- Is there a plan to fill the life of the retiring entrepreneur?

Relationships of family members to each other:

- Do the family members respect the diversity of interests and abilities of other family members?
- Is there already distrust, jealousy or acrimony?
- Is there a plan to keep intra-family communications open?

Sometimes these problems prevent the parties from ever getting to the other issues discussed in this outline, or the parties begin the succession

process but cannot complete it. In those cases, a **management consultant, organizational specialist** or **mediator/facilitator** who is experienced in succession planning and family business issues can help the parties “over the hump” so that they can act to achieve a smooth management and ownership transition and to preserve the business.

### 3.2 Business Considerations

Is there a desire to pass the business to family members who are active in the business?

Are there already children who are willing and able to run the family business?

When shall control shift from older to younger generation?

- Is the older generation willing to train the younger generation?
- Can the older generation let go?

Will the older generation need post-retirement cash flow from the business?

Can the cash flow of the business support a buy-out?

Are the expectations of each generation realistic?

The **accountant** for the business can prepare projected financial statements and cash flow analyses to help the owners to select from several possible alternative plans.

Often the outside accountant who prepares the financial reports and tax returns for the business has a long-term relationship with the owners. As a result, the accountant can provide invaluable insights to all of the owners’ advisors.

When the accountant is not in a position to prepare projections or prefers not to be seen as taking sides in a controversial succession plan, a **management consultant** can help the parties develop and implement an effec-

tive succession plan. In a difficult situation, a management consultant might ask all of the principal parties (owners, successors and other key family members) to participate in an off-site weekend retreat to discuss the problems thoroughly and to try to resolve them.

### 3.3 Ethical Concerns

The advisor must identify whom he or she represents. This is particularly critical for **attorneys**. The client often wants one advisor for the entire family and the business, but their interests can easily conflict and the attorney should anticipate this. Even married parents can have conflicting objectives that can prevent one attorney from representing both of them.

## 4. THE PLANNING PROCESS AND THE TEAM APPROACH

Succession planning is difficult, often takes a long time to implement and usually requires more than one expert. For the business owner with an estate worth several million dollars, failing to plan can damage the business. Most owners do not have succession plans, and two out of three successful businesses do not survive the transition to the second generation.

An advisor who is not comfortable with succession planning techniques should bring in an expert in at least one area of succession planning (tax, insurance, appraisal, investment banking, family counseling or management consulting) with the understanding that this expert will help the owner to identify specialists in other areas as they are needed. This “loose confederation of experts” approach is often the best way to address the complex issues involved.