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Succession: Passing the torch

Statistics suggest that it's one of the greatest threats faced by family-owned companies — and utterly preventable. Here, our wealth strategy professionals offer a road map to the process that may help you protect your wealth and extend your legacy.

A dozen years ago, when the founder of a successful car dealership chain decided to retire, he knew exactly whom he wanted to take control of his company. His son and two daughters were actively involved in the business, and all were well prepared to take the reins. Sure enough, the transition was seamless, and the car dealerships continued to grow. By 2018, the company was worth more than $100 million.

Then, in 2019, the older daughter died suddenly. As part of the transfer of the company from their father, the new owners had a portion of their succession plan in place — a buy-sell agreement that specified how company shares would be transferred if one of the three left the business. There was one problem, says Scott Cooper, managing director of Merrill's Wealth Structuring group: The life insurance policies that had been taken out to fund the agreement had been allowed to lapse. When the older daughter passed away — with most of her $50 million estate tied up in the closely held business — her siblings had scant liquidity to cover the 40% federal estate tax. "They had to come up with $20 million to pay Uncle Sam," says Cooper. "To do it, they had to jump through hoops, scraping together cash and taking out a large loan. It could've been worse. They could have lost the company."

When it comes to succession planning, partial measures aren't enough. Most business owners seem to recognize the importance of having a succession plan. According to the *2018 U.S. Trust Insights on Wealth and Worth®* survey, more than half of all business owners plan to leave their business within the next five years, and while two-thirds of all business owners (including those already retired) say they have or had a succession plan for their business upon leaving it, only one-third have a robust, documented plan that's been communicated to those it affects.[1] Only 28% of business owners plan on selling or transferring ownership to a family member, and 22% of owners have an informal plan that includes nothing more than a verbal agreement, a simple written memorandum or a general idea in mind.[2]

Why the disconnect? Most entrepreneurs have their hands full planning for the next quarter, let alone trying to think about what will happen to their company when they're gone. Seeing the larger picture can be difficult, and that can cause issues when planning. There are two levels of essential planning: planning for things that could go wrong — such as an unexpected death — and planning for when things go right. Many families stop their planning at the first level, thinking that wills and trusts designed for when things go wrong are enough for when things go right. That is not always the case. Doing what's required to help ensure a smooth transition also means tackling a host of delicate issues.

[1, 2] *2018 U.S. Trust Insights on Wealth and Worth®* survey.

Few business owners relish having to pass judgment on which — if any — of their children have what it takes to carry on their work, or deciding how the children outside the business will be compensated. “Often there are no easy answers to these questions,” says Gary Howell, director of Merrill Family Office Services. Add the pressures of operating during challenging economic times, and it’s easy to understand, says Howell, “why succession planning just falls down the list.”

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As the case of the car dealerships shows, there’s financial peril in this land of procrastination. Lack of succession planning is one reason why. According to the same survey, seven in 10 business owners who own companies where family members are involved admit that it’s difficult to separate the needs and dynamic of the family from the needs and goals of the business. Seventy-three percent of small business owners believe that the involvement of family co-owners or leaders in the business complicates business decision-making. Those are the sort of sentiments that can easily lead the current generation of owners to delay succession planning. In the absence of a plan, notes Kurt Trimarchi, a partner in the accounting firm McKonly & Asbury, “someone else is going to end up dictating how your company’s assets are transferred.” And it’s a safe assumption that that person will be less invested in the outcome than you are.

Additionally, the demographics of an aging business-owner population point to a large wave of businesses that must transition. The adage “There’s no time like the present” has perhaps never been truer as it relates to securing the future of family-owned businesses. “Now is the time to ask, ‘What is my exit strategy?’ and then take the steps to carry it out,” says Trimarchi. “Even if you decide that the actual transition won’t be for many years, if you have some sense of what you’re building toward, you’re much more likely to get there.”

Choosing a successor

There’s another reason people put off succession planning: The strategies involved — buy-sell agreements, trusts and other abstruse legal instruments — tend to be complex, time consuming and difficult even for lawyers to parse. Business owners know they need to do it but don’t necessarily embrace it with a huge amount of enthusiasm. What entrepreneurs often fail to realize, though, is a thoughtful and thorough succession planning process can actually strengthen their business operations. By thinking through the delicate issues and getting them down on paper, they’re engaging in a rigorous form of long-range planning. Weaknesses in bench strength or capital reserves, which might otherwise have been allowed to slide, bubble to the surface and can be addressed. At a time when many wealthy families are more focused on personal retirement and legacy issues, a business succession plan is also essential for protecting current owners’ visions of their after-work lives. “Owners’ assets are often tied up in their businesses,” says Trimarchi. “Even after they’ve handed off their business to someone, that dream retirement they have in mind may depend on the continued success of that business.” The same goes for philanthropic pursuits and other legacy goals. The first step, as Trimarchi notes, is to decide on what your exit strategy is going to be and whom you intend to leave in charge. In some companies, a successor will emerge naturally. Other family businesses undergo a more formal process, rotating interested children through various roles inside the company as well as out to gauge their attitudes and aptitudes.

Counteracting sibling rivalry: Equitable versus fair

Once a successor, or group of successors, is tapped, the decision process refocuses on how to structure the company to reward the new owners while also providing fair compensation to any children who weren’t drawn to the business. A common solution is simply to divide stock in the business equally among all children but to give voting shares only to those who will run the company. Yet while that approach may seem equitable, it can cause the children who aren’t involved in the business to feel hamstrung in protecting their interests — which, after all, may represent a significant portion of their net worth. “Kids working in the business can give themselves big raises and strip out all of the value of the company,” cautions estate planning attorney Elizabeth Morgan. At the same time, operating shareholders may come to resent the fact that siblings outside the company stand to gain from an increase in value they didn’t help create.

A carefully drafted — and properly funded — buy-sell agreement can spell out provisions to account for all these contingencies. The agreement could give the nonvoting family members outside the company the right to force the insiders to buy their shares within a specified period, and give the voting shareholders the same power. “You have to give the children a mechanism with which to pull away from each other,” says attorney Eric Manterfield.

The very act of drafting the buy-sell agreement may force business owners to deal with important questions they hadn’t considered before. For example, most agreements stipulate that the price of the shares is based on the value of the business at the time of the sale. “But one key issue is whether the minority, nonvoting interests are going to be discounted for lack of marketability,” says Manterfield. Because few outsiders want to buy a minority stake in a privately held company, the value of such shares may be discounted by 30% to 50%. That can be an advantage to the parents transferring the shares because it minimizes their gift or estate tax liability. On the other hand, it may not sit so well with the children on the receiving end of the reduced-price stock.

And there’s another problem with dividing shares equally: Even voting siblings rarely agree on everything. Unless parents have an odd number of children in the business, deadlocks can occur. That’s why some parents who apportion shares equally among their heirs also choose to retain a small tie-breaking stake for themselves — a Solomon-like approach that has an added advantage of satisfying whatever ambivalence the founders themselves may have about letting go. “That way, even while passing along an economic interest that can benefit the kids and reduce taxes,” says Cooper, “they’re ensuring that it will be a long time before they have to give up control.”

In a rising income tax environment, basis step-up — the reevaluation of assets during a wealth transfer — is an important consideration.

Solutions to the question of what is fair are many, but one is to plan to make things go right. According to Cooper, one way to help ensure this is to find ways to structure the family holdings so that those children who are active in the business ultimately own it independently from their inactive siblings. “We look at the entirety of the family’s wealth and consider alternative ways to divide it,” he says. “That includes options such as using life insurance to pass wealth to inactive family members. Siblings may fight as children and many may as adults, but putting some siblings in financial charge of others can create permanent misery for all.”

Tax considerations

In preparing a business succession plan, the business owner is essentially protecting his company and his family from two types of taxes that historically have been among the most punitive in the U.S. tax code — the federal estate tax and the federal gift tax — as well as protecting them from increasing income and long-term capital gains taxes. Federal legislation in recent years — notably The Patient Protection and Affordable Care Act of 2010, The Health Care and Education Reconciliation Act of 2010, The American Taxpayer Relief Act of 2012 and the Tax Cuts and Jobs Act of 2017 — has introduced changes to income and transfer tax rules. For business succession purposes, there are some meaningful changes to rates and exemptions.

While a complete and detailed discussion of the changes is beyond the scope of this paper, we can explain a few items here. Federal income tax rates remain high: The maximum rate for ordinary income and short-term capital gains is now 40.8%, and the maximum rate for long-term capital gains and qualified dividends is 23.8% (both tax rates include the 3.8% Net Investment Income Tax). The federal estate, gift and generation skipping transfer tax rates remain at 40%. The transfer tax exemption amount was recently doubled from \$5 million adjusted for inflation (\$5.49 million in 2017) to \$10 million adjusted for inflation (\$11.58 million in 2020), but will return to \$5 million adjusted for inflation after 2025. State law changes can impact your planning as well, as some states have increased their tax rates. It’s possible that business owners living in high-income tax states could see combined long-term capital gains rates of over 37%. In the planning community, many advisors are looking closely at trade-offs between transfer-tax savings and a loss of step-up in basis of assets. In a rising income tax environment, basis step-up — the reevaluation of assets during a wealth transfer — is an important consideration.

In any event, any business owner considering selling a business has a strong incentive to begin laying the groundwork now. In the simplest scenario, for example, a husband-and-wife business-owner team might decide to sell their business to their children on an installment basis. Using their combined lifetime gift tax exemption, they could give their children up to \$23.16 million of the down payment in 2019, completely tax-free, and then have the kids sign a promissory note for the balance. That would let the children repay the parents gradually out of profits from the company and provide the parents with regular payments for the length of the note. The only problem with this approach is that the parents would still owe capital gains taxes on the sale, payable over time with each payment that they receive.

Even so, there are other, somewhat more intricate, approaches that may allow them to reduce or eliminate their gift, estate and capital gains tax liabilities. “That’s why we usually encourage owners to transfer their wealth in trust,” says Cooper. Depending on the trust, parents can either transfer the company to the trust or sell it to the trust. In an intentionally defective grantor trust (IDGT), for example, they sell it to the trust, the one stipulation being that the trust should be funded with at least 10% of the value of the company it’s purchasing. So if the family business is worth $200 million, the trust would need $20 million in seed capital — all of which a couple could now provide using their combined lifetime gift tax exemption with a little left over. The trust could then buy the stock, usually at a discount for lack of marketability, and agree to repay the parents at a nominal rate of annual interest set by the IRS (1.17% as of 2020),[3] according to the terms of a mid-term note.

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While the shares sold to the trust are considered outside their estate, the parents, not the trust or its beneficiaries, will be responsible for the income tax due on the interest payments, as well as the income or capital gains tax if the shares generate dividends or are ever sold from inside the trust. That’s the “intentionally defective” aspect of an IDGT, says Howell — the defect is desirable, because paying the taxes further reduces the size of the estate outside the trust, while the trust’s proceeds go to the children with no gift or estate taxes due.

Though irrevocable, an IDGT also offers flexibility. When combined with other vehicles, such as a Delaware trust, a limited liability corporation (LLC) or a family limited partnership (FLP), the IDGT can allow parents to maintain day-to-day operational control over the company even as they’re laying a more tax-efficient groundwork for the future. Also, if a family ends up changing course and deciding to sell the business before the trust assets pass to the children, the trust can simply sell its shares, use the proceeds to pay off the note and still transfer the remainder to the children estate tax-free. That makes it a good option for business owners who might be eager to take advantage of the favorable tax environment but haven’t yet decided whether to keep the company in the family or transfer it to an outsider — whether that be an individual buyer, the public via a stock offering, or employees through an employee stock ownership plan, or ESOP.

Anticipating the unexpected

As the heirs of the car dealership learned the hard way, an unexpected death can put even the best-laid succession plans in turmoil. In their case, the problem was failing to fund their buy-sell agreement, but the consequence — having to face the possibility of selling the company to pay estate taxes — can befall any family. One way to guard against that and to further leverage the current tax opportunities is with an irrevocable life insurance trust (ILIT) that designates the children as beneficiaries.

Historically, the challenge with an ILIT was getting enough money into the trust to pay for a large enough policy without triggering substantial gift taxes. For 2019, a husband-and-wife business-owner team has a combined $23.16 million with which to fund a policy while still remaining under the exemption level, or enough to buy some $75 million to $100 million worth of coverage, according to Cooper.

When opportunity knocks

Not all succession planning, of course, is done to protect against unfortunate circumstances. It can also be used to increase the windfall from a more propitious event. Although the initial public offering (IPO) market for middle-market companies is nowhere near as active as it was a decade ago, it can still result in a major payday for a well-positioned company in the right sector. That could also spell a big capital gains tax — or far less of one with the appropriate use of a grantor retained annuity trust, or GRAT.

Suppose you intend to take your company public in nine months and expect shares to be priced at about $15, yet an appraisal now puts their worth at only $8 a share. You can choose to set up a GRAT that designates your children as the beneficiaries and pays you a lifetime annuity. At the time you place the shares in the trust, you will owe a gift tax, but only on the current valuation of the shares that exceeds your lifetime gift tax exemption. Moreover, the present value of the annuity

[3] The mid-term applicable rate for July 2020.

payments to you reduces the taxable value of the gift for tax purposes. (In fact, when properly structured, the taxable value of the gift to the trust can almost always be reduced to close to zero.) Any growth beyond that amount then accumulates inside the trust until the end of the GRAT term, when it goes to the beneficiaries entirely tax-free. Given the alphabet soup of business succession planning strategies — IDGT, LLC, FLP, ILIT, GRAT and more — there might be a temptation to put off getting serious about your company's plan for another time. But you could be making a large, and potentially costly, mistake. "Try not to think about it as one big project," says Morgan. "You can carve the planning into a series of more manageable stages. The most important thing is to sit down with your advisor, attorneys and accountants now to figure out the best way for you to take advantage of the wealth transfer provisions currently available to you. It takes time to get this right. But a succession plan will be worth every ounce of energy you put into it."

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Your Merrill advisor can help start the process and offer suggestions for how to deal with wide-ranging scenarios. After the two remaining owners of the car dealership lost their sister and then nearly lost their business, they realized they needed help creating a more robust plan. They also wanted to begin transferring ownership to the next generation in a tax-efficient way. Their advisor reached out to Cooper, who recommended that the siblings set up ILITs and purchase life insurance on each other worth 75% of the value of each sibling's stock in the company.

The brother then sold $5 million of his nonvoting shares, discounted for lack of marketability, to an IDGT, with his children and grandchildren as beneficiaries. "His stock was highly appreciated, so this avoided what would have been massive capital gains," says Cooper. And by paying income tax on his payments from the trust, he further reduced the value of his estate — another tax-free gift to his heirs.

Though the siblings don't know yet which of their children, if any, will take over the business, they have the beginnings of a plan in place. "Now the company is protected," says Cooper, "and the children and grandchildren are in line to receive the maximum benefit." That's the goal of every succession plan, and creating one now, no matter how strong the urge to put it off, will give you the best chance to succeed.

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