

Preparing for the Future – Business Succession & Managerial Transitions

CFESA

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Boston, MA

Resnick Associates

Questions to Ask Yourself

- 1. Am I Working Years, Possibly even Decades, to Build My Business only to eventually lose it?**
- 2. Will there be Infighting within My Family?**
- 3. What will be My Family and Business Legacy?**

The Leading Cause of Business Failure.....

**INEFFICIENT
SUCCESSION/ESTATE PLANNING!**

What is Succession Planning?

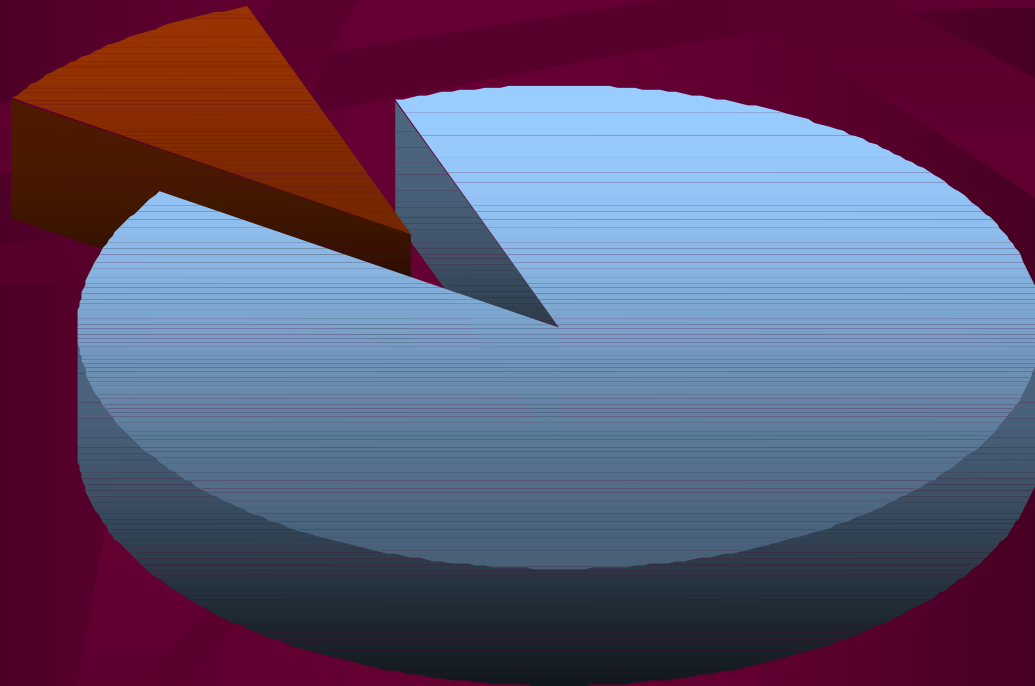
A Deliberate and Systematic Effort
by an Organization to Ensure
Leadership/Ownership Continuity

What is Estate Planning?

The Effective Preservation and
Transition of Personal and
Business Wealth

23.3 Million U.S. Businesses

10% Public/90% Private



2 OUT OF EVERY 3 FAMILY BUSINESSES WILL NOT MAKE IT FROM THE FOUNDER TO THE 2ND GENERATION!

- Original Owner Can't "Let Go"
- Lack of Plan or Inadequate Planning
- Each generational succession is *more difficult* – even if you've transitioned to more than one generation you must remain proactive

IMPORTANCE OF SEPARATING COMPANY FROM FAMILY

- Challenge to Parents: COMMUNICATION
- Family Meetings



**10 POINT
BUSINESS SUCCESSION
PLANNING CHECKLIST**

**Have These Issues Been *Properly*
Addressed?**

Issue #1

Define Personal Goals and Vision

Issue #2

Identify Your Successor

If you are a Family Business, is a Family Member the best choice to take over?

Issue #3

Techniques to Reduce or Eliminate Estate Taxes

Issue #4

Liquidity Positioning to Avoid the Forced Sale of the Company and Provide for Estate Equalization

Issue #5

Buy-Sell Agreements

- A. Stock Redemption
- B. Cross Purchase
- C. Wait and See

Issue #6

Contingency Plan in the Event of Disability

Issue #7

Stock-Transfer Techniques to Help Achieve Succession Goals

Issue #8

Parental Dependency on Business to Meet Retirement Cash Flow Needs

Issue #9

Business Valuation

**Is Succession to Family Members
or Outsiders?**

Issue #10

Independent Review of Existing Documents and Life Insurance to Confirm they Meet Current Objectives

Leading Causes for Unsuccessful Succession

- No Succession Plan
- Ineffective/Outdated Succession Plan
- Unable to Retain Key Execs/Personnel
- Disastrous Personal Estate Plan – Company left to Inactive Spouse and/or family members

American Taxpayer Relief Act of 2012

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An Inside Look

- Exemption Amount Increased to \$5m/individual and \$10m/married couple (during life, death or combination)...indexed for inflation
- Tax Rate 40%
- **Permanent?? As the saying goes “A law is only permanent until Congress decides to change it”**

FACT

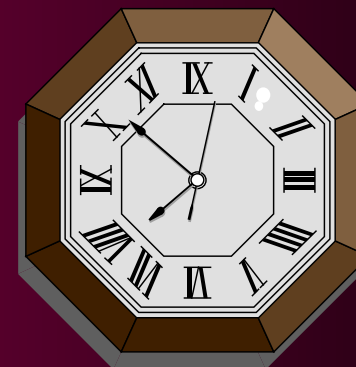
**PRIVATE FAMILY OWNED
BUSINESSES REMAIN AT RISK!**

What This Means for CFESA Members

Failure to Address Today's Issues will
Result in Costly Mistakes.....Including
the Potential Loss of your Company

Acquiring Assets

Planning For Estate



Most Common Mistakes

- Complacency
- Unrecognized Estate Size and Tax Hit
- Poor Liquidity Position
- Improperly Arranged Life Insurance
- Lack of Specialized Planning

Types of Trusts

- Revocable - Grantor **CAN** change or terminate the Trust
- Irrevocable – Grantor **CANNOT** change or terminate the Trust

Revocable or Irrevocable Trust?

Depends on the Planning Purpose



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Estate Analysis

- Assets – Both business and non business
- Assets to go to whom you want, when you want, and how you want
- Current Plan – Are you 100% certain this will happen?

Ownership of Assets

**How You Own What You Own
Decides How You Pass What You Pass**

Property in the Estate

Cash

Real Estate

Personal Property

Retirement Plans

Business Interests

Investments

Tangible Assets

Revocable Trusts

Annuities

Life Insurance

Annual Exclusion

- Gifts of up to \$14,000/year
- Present Interest
- No Tax, No Paperwork
- Joint Gift; \$28,000/year

Significant Gift and Estate Tax Reductions

Created through a combination of annual
gifting AND \$5,000,000 + Exemption
Amount

Unlimited Marital Deduction

- Dollar for Dollar Deduction on Assets Transferred to a Spouse
- Outright, Unconditional Transfer or
- Qualifying Trust (GPA or Q-Tip)
 - ... included in Spouse's estate at death

Advanced Planning

- Grantor Retained Annuity Trust
- Intentionally Defective Grantor Trust
- Private Annuity Sales
- Self Cancelling Installment Notes

Liquidity Needs In Estate Planning

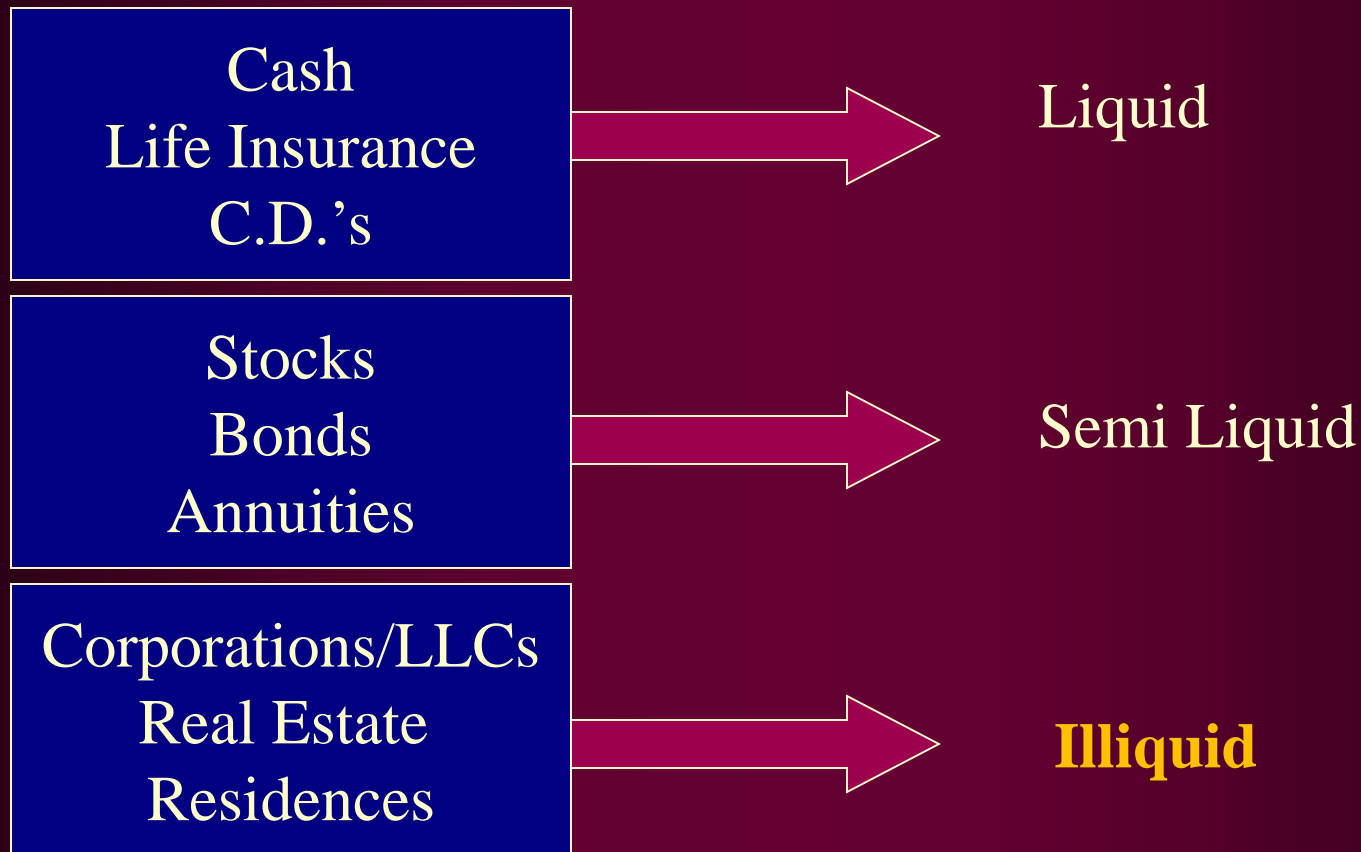
- Administration Expenses 2-5% of Gross Estate
- Federal Estate Taxes (within 9 months)
...often Deferred to Second Death
- Family Income Needs

Succession Planning

Liquidity Needs

- Buyout of Business Interests
- Capital to Strengthen Business at Transition
- Replacement of Key Executives
- Deferred Compensation Arrangements

Sources of Liquidity



METHOD TO PAY

Cash



- Reduces Total Bequest to Family
- Reduces Funds Family May Need for Current and Future Expenses
- Future Earnings on Funds are Gone
- Capital to run Company is Gone

METHOD TO PAY Sale of Illiquid Assets

- Reduces Total Bequest to Family
- Complete Loss of Future Income
- Unlikely to Receive Fair Value

RESULT

Valuable Asset is Gone

- Income Lost to Family Forever
- Stranger/Competitor Receives Future Income and Appreciation
- Family Receives Neither the Family Business/Property Nor Its Value
- IRS Receives the Cash

METHOD TO PAY

Life Insurance

- Assuming adequate insurability, the least expensive method to pay estate taxes and other required obligations
- Death Benefit May Be Estate Tax Free if Ownership is structured correctly
- Preserves Assets - including the Business
- Maintains Family Harmony

Life Insurance Ownership

Maintaining Estate Tax Free Status

- Irrevocable Trust
- LLC
- Adult Children

IT IS IMPERATIVE TO
UNDERSTAND THE
CONTRACTUAL LANGUAGE
IN YOUR POLICIES

What Type Do You Get?

- Term
- Universal
- Variable
- Variable Universal
- No Lapse Universal
- Whole Life
- Whole Life / Term Blend
- Individual or Second to Die

CONCERN AND CAUTION

- Variable
- Universal
- Variable Universal
- No Lapse Universal

Variable Life

Universal Life

Variable Universal Life

The following items are NOT guaranteed

1. Premium
2. Cash Value
3. Death Benefit

Life Insurance is an ASSET

The second largest ASSET for most business owners is the face value of their life insurance.....

However.....

Most Business Owners Do Not Understand the Insurance They Have – This leads to significant problems With Their Estate and Succession Plans

Company Safety is Critical

- Was your life insurance acquisition based upon strict due diligence?
- Do you know the Comdex Score of your insurance company(s)....have you ever heard of a Comdex Score?
- Are you certain, with all the changes in the market place, that you have policies with the lowest *net cost*?

“I thought Life Insurance was Tax Free”

- Income and Estate Tax Situations
- Ownership of Policy must be set up correctly
- **Pension Protection Act of 2006!!**
- Three Party Contracts

Valuation

Important for Lifetime Gifts and Testamentary Transfers

Fair Market Value

What a Willing Buyer Would
Pay a Willing Seller, Neither Being
under a Compulsion to Buy or Sell
and Both Knowing All Relevant Factors

Valuation

IRS Revenue Rulings

Key Ruling - 59-60

Earnings
Capacity

Book Value

Dividend
Capacity

Marketability

Risk Closely
Held

Market Factor

Publicly Held

Minority
Discounts

Control
Premium

Business or Surviving Shareholder Required Financial Obligation

\$ 5 MILLION BUYOUT AMOUNT

What are the Choices to Fund a Buyout?

- **Borrowing**
- **Installment Method – Commonly Used**
- **Life Insurance**

Case Study

F&F, Inc.

- Frank and Fred are equal owners of F&F, Inc. – a profitable S Corporation
- F&F, Inc. valued at \$10,000,000
- Buy-Sell Agreement **REQUIRES** surviving owner to purchase deceased owner's interest for \$5,000,000 under an installment contract payable over 10 years **PLUS** interest

Installment Method Overview

- Installment payments are NOT deductible by F&F, Inc.
- Frank and Fred are individually in a 40% marginal federal and state tax bracket
- F&F, Inc. operates on profit margin of 10% for every dollar of sale

Installment Method Financial Reality

- **Annual Installment Payment is \$500,000 (not including interest)**
- **Surviving Owner has to earn nearly \$850,000 in income to net \$500,000 in a 40% marginal federal and state tax bracket**
- **To earn \$850,000, the surviving owner has to generate annual sales of \$8,500,000, which is \$85,000,000 over the ten year installment period!**

Installment Method Issues

- **Could either surviving owner generate enough profit to pay the installment obligation AND still earn a good income for his personal needs?**
- **Will the death of an owner have a negative impact on sales? How is that going to be made up?**

More Issues.....

- **Will the survivor have to hire someone to take over the responsibilities of the deceased owner? Where is the cash flow coming for this? How much more is needed?**
- **Will the installment obligation affect the ability of the Company to pay salaries, borrow money, expand or fulfill other business purposes?**

What Happens.....

- **To existing company debt when one owner is deceased or out of the business because of a disability?**
- **If the company or surviving owner becomes insolvent during the installment period?**
- **If the surviving owner dies or becomes disabled during the installment period?**

Advantages of a Formal Buy-Sell Agreement

- Surviving Owner maintains Continuity of Ownership and Management
- Decedent's Estate / Family Converts Unmarketable, Non-Liquid Business Interest to Cash
- Provide Fair and Reasonable Price

Types of Buy-Sell Agreements

- Stock Redemption
- Cross Purchase
- Wait and See

Buy-Sell Agreement

Key Components

- Language that addresses all contingencies
- Valuation
- Funding

Stock Redemption Plan

- Al and Bob Form Corporation & Each Contributes \$500,000
- 10 Years Later Corporation is Worth \$10,000,000
- Al and Bob Enter Into a Stock Redemption Agreement
- Corporation Becomes Owner and Beneficiary of \$5,000,000 Policy on Both Al and Bob

Stock Redemption Plan

Al Dies:

- \$5,000,000 Death Benefit is Paid to the Corporation
- Corporation pays \$5,000,000 to Al's Estate
- Al's Estate Redeems Stock Back to Corporation
- Bob's Stock is Now Worth \$10,000,000 (Same # Shares, Twice the Value)

Stock Redemption Plan

- Bob Decides to Retire and Sell Corporation for \$10,000,000
- Bob Must Pay Capital Gains taxes on \$9,500,000 (\$10,000,000 Minus Original Cost Basis of \$500,000)

Cross Purchase Plan

- Al and Bob Form Corporation & Each Contributes \$500,000
- 10 Years Later Corporation is Worth \$10,000,000
- Al and Bob Enter Into Cross Purchase Plan

Cross Purchase Plan

- Al is Owner and Beneficiary of \$5,000,000 Policy on Bob
- Bob is Owner and Beneficiary of \$5,000,000 Policy on Al

Cross Purchase Plan

Al Dies:

- Bob is Paid \$5,000,000 from Policy on Al's Life
- Bob Pays Al's Estate \$5,000,000 for Al's Stock
- Bob now Owns \$10,000,000 of Company Stock

Cross Purchase Plan

- Bob Decides to Retire and Sell Corporation for \$10,000,000
- Since Bob bought Al's Stock for \$5,000,000 and had \$500,000 Original Basis...
- ...Bob Pays Capital Gains Taxes on \$4,500,000
- **RESULT.... Tax Savings on \$5,000,000**

Summary.....

- Buy/Sell Agreements are more than a Business Planning Strategy
- If drafted and funded properly, they protect everyone – owners and their families and employees and their families
- Be cognizant of design to avoid possible unnecessary taxes in the future

Successful Transition for Al's
Family and Bob.....Right?

MAYBE NOT!

WHY???

**The Buy-Sell Agreement was
Never Updated.....**

What's Changed?.....Plenty!

Al and Bob each had a child working in the business for years and Al and Bob both want their child to have future ownership

Let's Talk about AI's Child's Ownership Future

Not a Very Long Discussion!

SPECIAL CASE STUDY

YOUNG FAMILY AND ABC, INC. **ESTATE/SUCCESSION PLAN**

Case Facts

- Parents, Louie and Louise Young, Ages 65 and 63 - Both Active
- Three Children:
 - Joe, Age 33 and Unmarried
 - Moe, Age 30 and Married to Nora
 - Helena, Age 27 and Married to Ken
- Louie, Louise, Joe, Moe each own 25%
- Fair Market Value of ABC, Inc. is \$7,000,000
- Louie and Louise Estate Valued at \$10,000,000

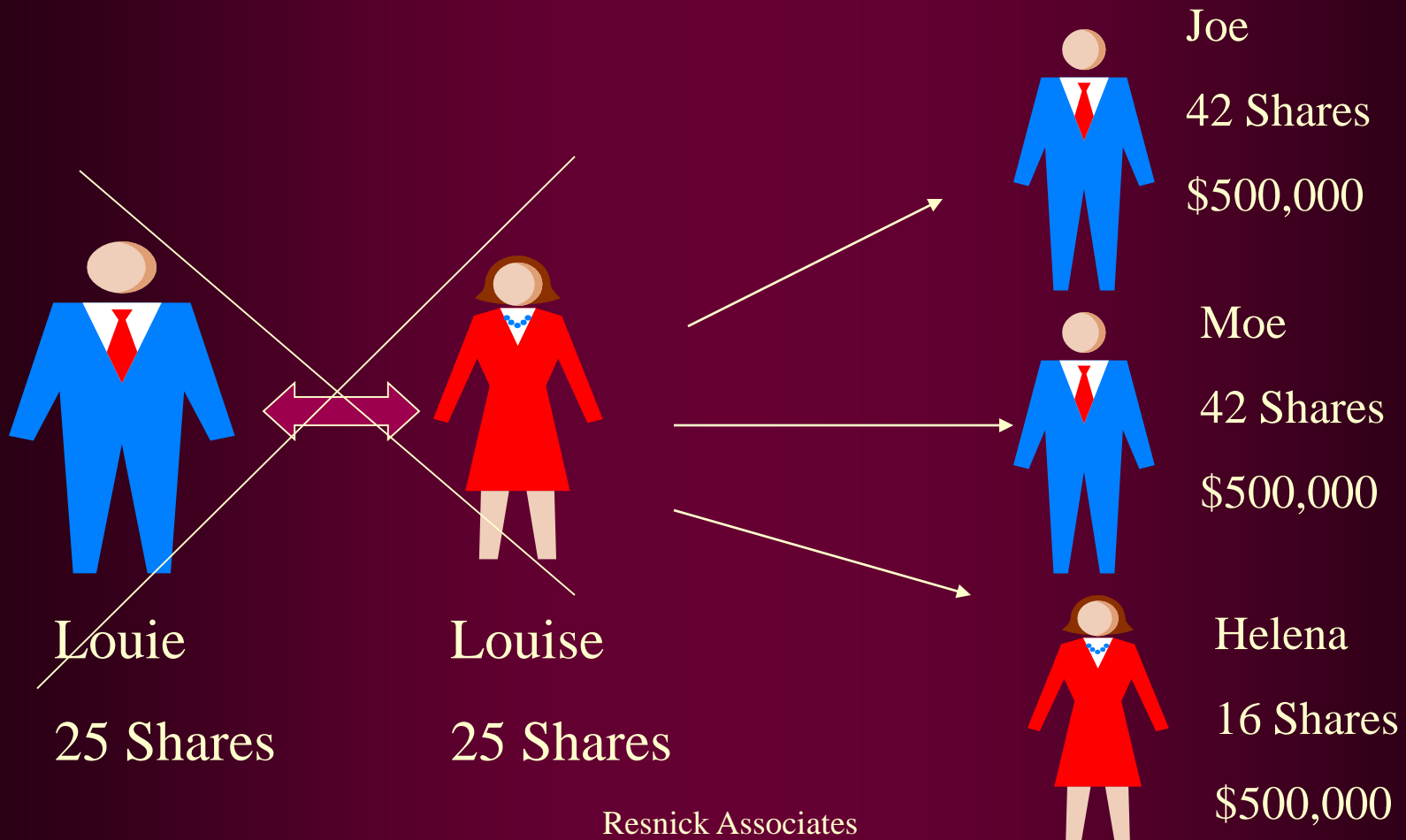
Current Plan

- Louie and Louise have Simple Wills
- At Second Death, Estate is Distributed Equally among the Three Children
- There is no Buy-Sell Agreement
- Moe and Helena have Simple Wills
- Joe does not have a Will

Goals

- Distribute the Estate Fairly Upon the Last to Die of Louie and Louise
- Assure that ABC, Inc. is Run by the Two Sons, Joe and Moe, Who are Active in the Business
- Provide Non-Business Assets to Daughter, Helena

Possible Results of Current Plan after Death



Possible Results of Current Plan At Moe's Subsequent Death



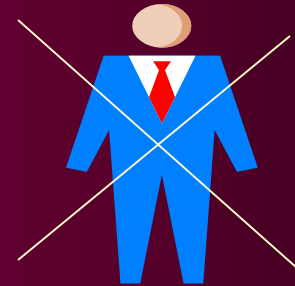
Nora

42 Shares

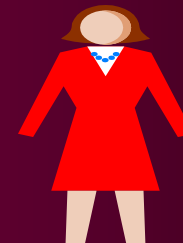


Joe

42 Shares



Moe



Helena

16 Shares

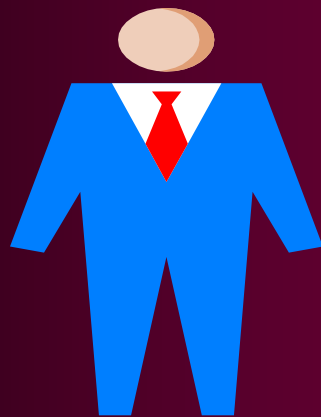


Results of Current Plan at Moe's Subsequent Death

- Nora and Sister-in-Law Helena Together Control ABC, Inc. and can sell the Company
- Joe, the President of the Company has Lost Control of ABC, Inc.
- Who is Running ABC, Inc.?

Solutions/Step-One

Cross Purchase Agreement

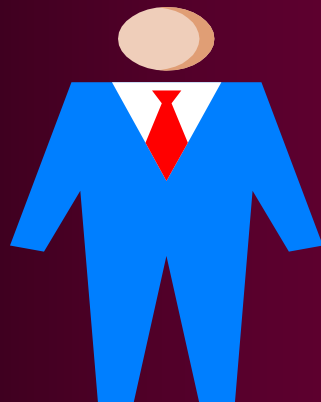


Louie



Louise

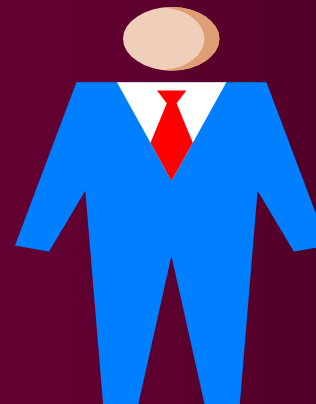
Assets Transfer
to Survivor at
first death



Joe



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Moe

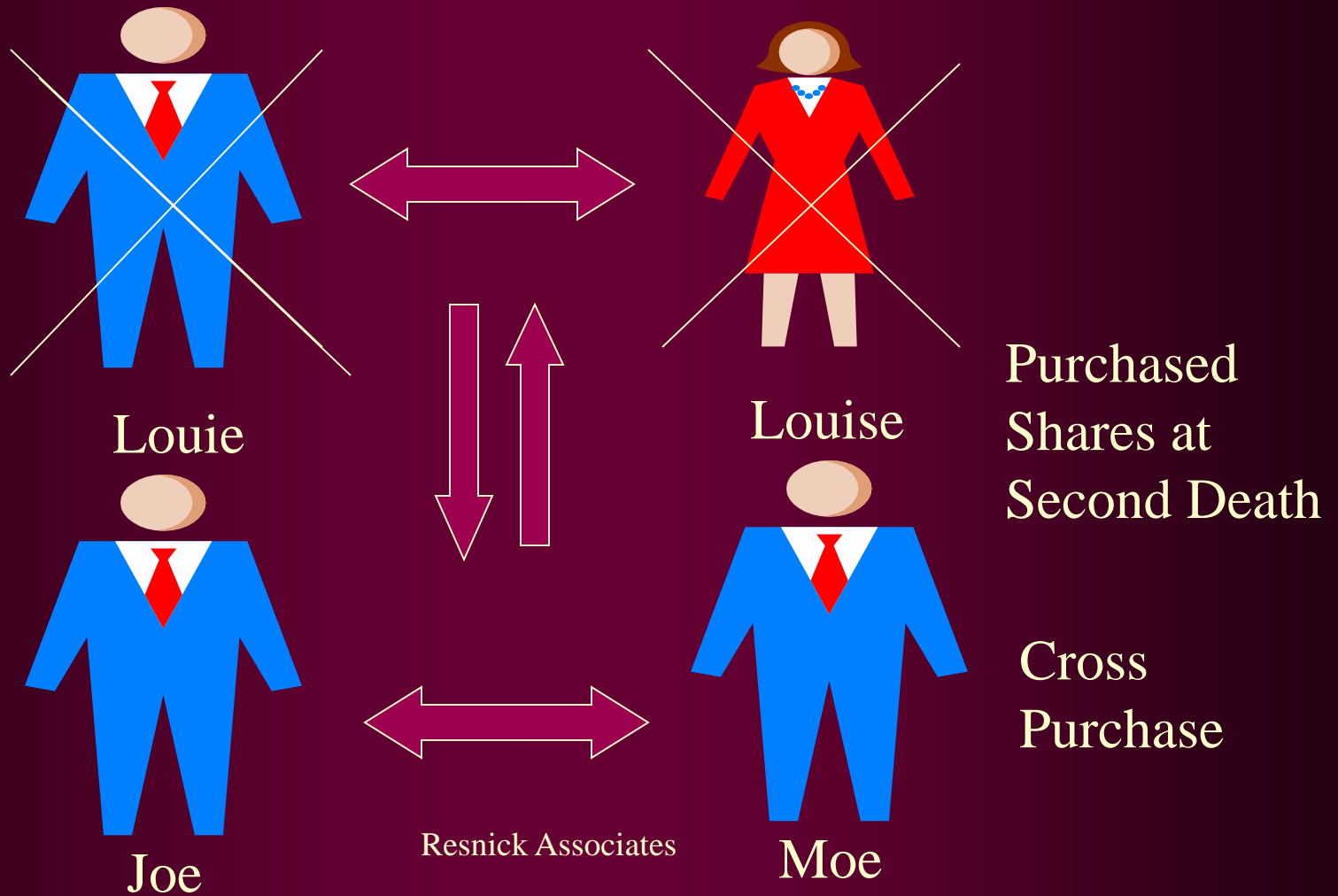
Brothers
Purchase
Shares at
Second Death

Cross
Purchase

Solution/Step Two

- After Sons, Joe and Moe Buy Shares, Their Parents' Estate Has \$3,500,000 in Newly Created Liquid Assets
- Parents now Have the Ability to Increase Cash Distribution to Helena

Possible Results/New Plan



Possible Solution Totals



Joe

\$1,000,000

50 Shares



Moe

\$1,000,000

50 Shares



Helena

\$3,250,000

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