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INSIDE THE MINDS

Family and Business Succession Planning

Leading Lawyers on Evaluating Recent Trends, Navigating Uncertain Tax Laws, and Developing Creative Strategies for Families and Businesses

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A Proactive Approach to Help Clients' Businesses Operate Smoothly in Times of Transition

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Introduction

Effective business succession planning requires that business owners contemplate many different possible business transition periods, not just planning that is effective upon death. Accordingly, the advising attorney must work with the business owner to plan for continued business operations during periods of the owner's temporary or permanent incapacity, another owner's transition event, and death of the owner. However, all such planning must strive to preserve the business owner's objectives, tax planning, and business operations procedures that were established by and remain valuable to the owner.

Succession Plans Should Be Proactive, Not Reactive

As individuals live longer and have greater access to medical treatments that can provide recovery from multiple medical events, it can be more challenging for entrepreneurs and business owners to decide when it is necessary to begin, and how to structure, succession planning. Moreover, because of the pace of medical advances, it can be challenging for involved persons to understand when it is the right time to step into fiduciary roles with respect to any business succession plan.

Thus, owners and operators of closely held businesses must plan for the continued operation of their businesses through both temporary and permanent succession events. The decision as to who will act, how, and when, is best decided early in the corporate growth process, not only when necessitated because of a medical event. Too often, business owners do not plan for succession during calm periods of operation, when time can be invested to analyze, assess, and plan for succession. If such time is not available because of a medical emergency, the succession planning can be stressful, incomplete, and reactive to a situation. The likelihood of a successful succession plan being created during a crisis is far less than when time for consideration is available.

Ensuring a Business Can Operate Smoothly During a Period of Transition

Today, we must be conscious of the extended lifespans of our clients. The goal of estate planning and business succession is not only to transfer the

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business assets upon death, but also to make certain the business is able to operate smoothly during any period of transition, whether it be death or incapacity. When working with a business owner, it is critical the attorney focus upon both issues that arise during life and death of the owner. With regard to such lifetime planning, many attorneys commonly prepare a power of attorney for the business owner, which provides a designated agent with powers to operate the business during the owner's incapacity. The use of such a power of attorney can provide relief for the short term, but it is not optimal as a long-term solution. The agency relationship created by a power of attorney does not provide the attorney-in-fact with the requisite authority to properly run the business and fully navigate the gambit of issues to be faced. Instead, it also is important to consider trusts to hold the business interest, which appoint a specific business committee to whom the powers of the trustee will be delegated with regard to the day-to-day operation of the business. Typically, this business committee is composed of both family members and key business personnel. The idea is to create a committee of individuals that is well balanced, having those with a potential ownership interest either currently or in the future, and others who are seasoned veterans with regard to the operation of the specific business at hand or the industry. In creating this business committee, great thought must be given to its members and composition, tenure on the committee, and the specific powers and authorities granted.

Additionally, it can be advisable for the trust to nominate an incapacity determination committee, which is separate from the business operations committee, to conclude whether the business owner has capacity. Providing for an incapacity determination committee that is distinct in membership from the business operations committee can reduce conflicts of interest between the owner and those who assume business control upon incapacity. Such group that determines the capacity can also be utilized to restore capacity when appropriate.

Characteristics of the Business Operations Committee

When evaluating healthcare issues, the attorney must focus on what authority the business owner needs to grant to the business committee to preserve the business operations and value. Such an evaluation must be based in an understanding of the internal workings of the business and the

key personnel. It is advisable to ask the client to prepare an organizational chart, and, at times, interview key personnel to help assess individuals' strengths and weaknesses to function in concert with the business committee and suitability for serving on such committee.

When defining the scope of responsibility of the business operations committee, it is important to enumerate the specific authority of the committee and make certain this authority dovetails with any of the corporate governance documents, particularly if there are other non-family owners. Additionally, consideration must be given to the perceived or assessed value of the business that exists because of the unique contributions and expertise of the owner. Thus, it is essential to plan with the business owner client for the difference between a temporary and a permanent incapacity situation. More specifically, businesses often are driven by the owner, and the value can be associated to some degree with the reputation and abilities of the owner. If a business is highly driven by the owner and the business may likely have a diminution in value in the event of such owner's incapacity, it may be advisable to direct an orderly sale and disposition of the company over a short period of time to maximize value. To the contrary, if a strong management team is in place and there is sufficient diversification of governance, the business may be able to continue during the owner's incapacity for an extended period of time.

The attorney should never pretend to know the client's business and should realize that each entity is unique. It is essential to spend time with the owner to gain a thorough understanding of each business's key personnel, weaknesses, strengths, competitors, and the overall business environment when deciding whether it is advisable to continue a business during a long-term incapacity of the owner or instead to accelerate its disposition to maximize value.

Avoiding a Guardianship

Business owners often view guardianship in the negative. Such business owners may express fear that court supervision of their affairs is expensive, cumbersome, unnecessary, and, perhaps, detrimental. However, guardianship may be necessary as the only alternative when the business owner has not

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created a business succession plan that nominates fiduciaries to ensure the operations of assets during periods of the owner's incapacity. In short, we strongly recommend a business owner spend the time necessary to plan for succession to avoid a guardianship.

When working with a business owner, it is important to understand the guardianship laws of the state within which he or she resides. Guardianships are typically creatures of court and court supervision. Unfortunately, this usually does not create the optimal environment for the success of the business or its operation. Most, if not all, of business succession clients try to avoid a guardianship through thorough business succession planning. While pre-need guardians may be named in advance by the business owner, or a temporary or permanent guardian can be appointed by the court, all guardians are subject to court supervision, annual reporting, and other mechanisms that may not be well suited for the management and operation of the business, which typically can be subject to volatile market conditions. Accordingly, it is important to specify in estate planning and business succession documents that in the event of the appointment of a guardian, the guardian will have no power or authority with regard to the operation of the business.

Additionally, if a business succession plan is in place and a guardian's authority with respect to the business is limited, it will be more challenging for an individual who was not granted power over the client's business affairs to try to obtain control through a guardianship process with the intention to circumvent the business owner's estate and succession planning. Accordingly, we believe it is important to provide for business succession both in a power of attorney (which has its limitations due to simply being an agency), and, more significantly, in a trust dovetailed with corporate governance documents (in which the entrepreneur can delineate the specific authorities and powers of a person or committee in charge of specific business activities). The use of a guardianship should be limited, and only for such circumstances when alternative planning is not in place.

Probate May Offer Protection

In dealing with business owner clients, we always enter into a discussion of the probate administration process. Most clients have a misunderstanding of the

probate process and believe it to be a cumbersome, expensive administration that will hamper or delay the settlement of an estate and the operation of its business. In fact, in Florida and many states, the probate process can serve to help expedite the distribution of assets, and protect the business assets, of a client from potential threats posed by creditors—whether that creditor is valid or invalid, a competitor, employee, or family member.

We typically structure our business succession planning in a manner that does not directly cause the "probate" of business assets. Such probate avoidance can be accomplished with lifetime ownership of assets titled to, and testamentary dispositive provisions placed within, a revocable trust instrument. However, we typically recommend that upon a business owner's death, a formal probate administration be commenced whereby the estate has the ability to notice all creditors or potential creditors of the owner's death. If such notice is properly provided through a probate process, it may abbreviate the statute of limitations for an alleged creditor to step forward and make a claim against an estate from a much longer period of time to a short period (in Florida, for example, limiting a two-year statute of limitations to approximately ninety days). Shortening the period of time when a creditor, potential creditor, or alleging creditor may make a claim against the estate or the entrepreneur allows the business to continue in a more knowledgeable position.

Often, estate representatives are hesitant to send notices to creditors or possible creditors, fearful it may cause such parties to file a claim against the business, decedent, or estate. In practice, however, it is often best to flesh out such claims early so they can be addressed, rather than waiting out the longer statute of limitations provided by most states with unknown circumstances that can impact the succession plan. During the business succession planning, it is critical for the owner to collaborate with key personnel, other family members, and other owners to determine if there are specific employees, competitors, or others who may pose a challenge to a will or trust that may potentially cause disruptions in the business succession implementation.

Additionally, if business succession is planned without a trust (for example, by a last will and testament and durable power of attorney/guardianship), probate is the process whereby the fiduciaries are appointed to carry out the

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affairs of the estate, which may include the operation of the businesses. The probate process itself is necessary to obtain the court order appointing an executor and vesting the executor with authority to transact business on behalf of the estate. In summary, for entrepreneurial clients, probate administration may be *required*, but it also may be *advisable* to abbreviate the statute of limitations of potential creditors and establish who is in charge of the business.

Undertaking the Complex Process of Business Succession

Business succession is a complex process—and as such, it takes an extended length of time to properly plan. Start early and work on the process frequently. Most business owners are more interested in running their businesses than planning its succession—whether succession is devising the business to a surviving spouse or other heirs, or an ultimate sale of the business. However, to have a proper business succession plan, it is essential that the estate planner have a thorough understanding of the business, the business owner's goals and objectives, key personnel, and the environment in which the business operates. It takes a great deal of time to properly assess all of these aspects, and to create a plan to achieve the owner's broad succession objectives.

Shape the client's expectations by explaining that business succession is a process that typically can take months (or in certain circumstances, years) to properly implement. Also, advise your client the business succession process will be comprehensive, but, ultimately, a well-structured business succession plan will most likely achieve the client's most important business goals and objectives during a time that he or she is not able to participate by reason of incapacity or death.

Beginning the Planning Process

To begin business succession planning with a client, the attorney must learn the business much as an appraiser initiates a valuation. First, the attorney should request from the client and review company records (for example, at least five years' worth of company financial records, tax returns, and statements; a company organizational chart; and existing company governance documents), and interview the owner and key personnel. All of

this is critical to having an understanding of the business itself and the key planning aspects. Many business owners do not understand the importance of this process and try to circumvent it to save money. It is important to advise the client that effective business succession planning is not something that happens overnight, but instead evolves over time. To avoid these initial steps is to take a shortsighted view.

Obtaining a master of laws, certified public accountant license, or other business experience also is beneficial to an attorney's understanding of business succession. There is a risk that without such business or financial education and certifications, an attorney's understanding of the scope of the business succession work is limited. Finally, the client's financial advisor should be included on the business succession planning team. It is imperative for the business succession plan to incorporate the necessary provisions from assessments of the client, the business, the law, and the client's finances.

Addressing the Client's Interpersonal Issues

Clients engaged in business succession planning are concerned about a host of issues. On the tax side, estate tax liability and how Congress will change the estate tax rate and exemption amount in the future is a significant concern for most clients. Clients looking to exit the business through a sale tend to focus more on income tax issues and how Congress will change the long-term capital gains rate in the future.

There are also many non-tax issues concerning clients engaged in the business succession process. These include how to prepare the next generation for an eventual ownership transition, when to implement the ownership transition to the next generation, and how to choose a structure or vehicle for implementing the ownership transition. When an ownership transition to the next generation occurs, it is critical for an appropriate entity governance structure, such as a board of directors or advisory committee, to be in place so the transition can be as smooth as possible both for the business and all of its owners.

Another key issue is management transition for the business, especially since there is an increasing trend whereby ownership transition of a family

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business does not necessarily coincide with management transition to the same person or persons. We have seen more instances recently where ownership was transitioned to the next generation, but management of the business was transitioned to an internal or external non-family member candidate. This creates a host of interpersonal issues between the senior generation, the next generation (who may have thought they would become the managers of the business), and the new management team. It is critical that these transitions are planned well in advance and are implemented thoughtfully and delicately to minimize turbulence for the business and the family.

Typically, we find it advisable to provide all parties having a material interest with an overview of the planned succession plan with the business owner being present. While this can be a complicated and stressful meeting to conduct, if properly carried out, it can serve to solidify the planning; obtain buy-in with those present; better manage goals and expectations of involved and future involved parties; and flesh out any overlooked issues. Many times this is accomplished in a series of meetings. While this part of the process will use every skill set of the attorney (from technical to dealing with complex family and interpersonal dynamics), it is a critical step in the business succession process. If the business succession process is properly planned and implemented during the owner's lifetime, typically few surprises should be encountered. Before initiating such "roll-out" meetings, it is critically important that the business owner is confident in the plan, as his or her demeanor will serve to set the tone at the meeting. Typically, we start with a brief overview of the process and then a reiteration of the goals and intentions of the owner. If the owner is willing and able, often it can be quite powerful if they conduct this portion of the meeting—at a minimum, they should express their concurrence with the planning. Some owners desire to forego this stage of the planning and prefer for it to be addressed after their demise or incapacity. Optimally, however, we find that such meetings serve to "hone" any rough edges and result in greater buy-in.

Successful Tax Strategies Incorporate Important Non-Tax Considerations

One of the most essential elements of a successful tax strategy is that it takes into consideration a number of important non-tax considerations.

While everyone wants a tax strategy that will minimize tax liability to the greatest extent, there often are competing interests that are even more important. The short-term and long-term goals of the business and its owners are the primary non-tax considerations that must be considered when developing a successful tax strategy. For example, sometimes the primary goal, which takes priority over maximizing tax savings, is providing retirement income for the founder, transitioning ownership to the next generation, or gearing up for a sale to a third party. Different goals have a significant impact on what tax strategy makes the most sense. Therefore, the tax strategy must take into consideration these objectives, and, ideally, allow for flexibility if and when the goals and objectives change.

Another key element of a successful tax strategy is that it is holistic and takes into account the various types of taxes that can affect a family business and its owners. These include not only estate and gift taxes and income taxes, but also can include international tax issues if the business operates globally. A tax strategy certainly will not be successful if, for example, it cleverly solves an estate tax issue, but does not consider the negative income tax impact created by the estate tax solution. Issues pertaining to *all* of the relevant taxes must be analyzed together to create a successful tax strategy.

Business valuations, including valuations of the ownership interests of a business, are another critical component of a successful tax strategy for a family business and its owners. Using lack of marketability and lack of control discounting techniques to reduce the valuation of the ownership interests in the business is often the linchpin to the estate and gift tax aspects of the tax strategy. Business valuations also can be important from an income tax standpoint when contemplating a restructuring of the business into a different type of business entity or into multiple business entities to facilitate a business succession plan.

Using flexible and tax-efficient business entities is also a key ingredient in a successful tax strategy. It is critical for all types of business organizations to meld their business succession plans with an appropriate tax strategy that is aligned with the non-tax goals and objectives; however, there is not one type of business organization that is best for every business and tax strategy. A business succession attorney must understand the tax nuances between S

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corporations, C corporations, and tax partnerships to develop a tax strategy that will be successful for a particular business and its owners.

A successful tax strategy can have an enormous financial impact for the business and its owners. Solving or managing estate tax issues can mean the difference between whether a family can afford to transition the business to the next generation or is forced to sell the business to cover the estate tax liability. Income tax strategies can have a dramatic financial impact on a family business and its owners, especially when considering the multiplier effect of enjoying the benefits of the income tax strategy every year.

Minimizing the Effects of the Net Investment Income Tax

Business succession often includes the use of trusts and trust committees. Such planning is intended to help operate and guide the business through incapacity or death. The goal, of course, is to successfully navigate these issues and perpetuate the business into the future. Most business owners are actively engaged in their businesses. As such, they are not subject to the recently enacted I.R.C. § 1411[1] net investment income tax, which is applicable to certain excess income resulting from a passive activity (as particularly defined in such Internal Revenue Code section) or a trade or business of trading in financial instruments or commodities (as defined in such Internal Revenue Code section). Accordingly, if your client's business succession planning is structured through trusts or trust committees, to minimize the impact of this net investment income tax, it is essential for the party having responsibility for the business and its ownership interests to meet certain material participation requirements. This net investment income tax is often an overlooked characteristic of business succession planning, as business owners may wish to name fiduciaries to help make decisions or guide decisions for the specific officers who actually manage the business enterprise. If possible (and otherwise advisable), it can be best to name fiduciaries who will be actively involved in the business operation itself to minimize or even avoid the net investment income tax. Unfortunately, the more members there are in a committee, the more difficult this becomes, as the activities

[1] I.R.C. § 1411.

of one member are not attributed to those of the remaining committee. As such, in planning, identifying smaller committees, and, if possible, naming members who are actively involved in the business and will continue to be so, it may be best to try to minimize the application of this net investment income tax. Thus, when appropriate, business succession plans are being modified or drafted to address the net investment income tax and provide the business committee not only authority, but also the responsibility, to fulfill certain business activities intended to support the material participation requirements.

Conclusion

When deciding to assume a business succession practice, it is first important to assess your own personal skill set. To properly plan for a business transition, it is important to understand financial statements, have experience in business (whether through management of a law firm or other outside business activities), and have a detailed understanding of I.R.C. Chapter 14 and the corporate rules in the state in which you practice. Business succession planning is a unique area that involves not only technical advice, but also strategic and psychological advice as to how to perpetuate the business into the future and provide for successful transition to the next generations—or, if that is unavailable or inappropriate, how to develop an appropriate exit strategy.

In summary, start the business succession plan early and manage expectations by advising that this is a process that can take quite an extensive period of time to fully complete. Also, once the succession plan is complete, it needs to be updated to take into account the evolving needs of the business and its owner both during time of incapacity and death. A thorough understanding of the client's business and key personnel is critical for successful planning. Once the planning is completed, take the time to begin implementation of the planning by conducting overview discussions to obtain the necessary buy-in from those involved. Successful planning can allow the business owner to not only enjoy the fruits of successful tax planning, but also result in a successful transition to the next generation or, alternatively, implementation of an optimal exit strategy.

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Key Takeaways

- When working with an entrepreneur, it is critical they understand that business succession is a process that can take months or even years. It is critical to manage both the client's expectations and others involved. When working with an entrepreneurial client, the business succession planner must first invest the requisite time to thoroughly understand not only the client's goals but also the business itself and its strengths, weaknesses, and key players.
- Although everyone wants a tax strategy that will minimize tax liability to the greatest extent, remember that there often are competing interests that may be more important. The short-term and long-term goals of the business and its owners should be your primary non-tax considerations when developing a successful tax strategy.
- When working with an entrepreneur, remember to focus on incapacity issues as well as death issues. Using a power of attorney can provide the agent with powers to temporarily operate the business during the owner's incapacity but do not present an optimal long-term strategy.
- Encourage your client to form a business committee, composed of both family members and key business personnel, which can take over the daily operations of the business during a time of transition. This committee may be separate and distinct from an incapacity committee.
- Do not fear the probate process, which may provide protection from creditors by substantially shortening the statute of limitations to make a claim against an estate.

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