

Business Succession Planning

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MARVIN E. BLUM, J.D./C.P.A.

The Blum Firm, P.C.

mblum@theblumfirm.com

www.theblumfirm.com

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MARVIN E. BLUM

THE BLUM FIRM, P.C.
777 Main Street, Suite 700
Fort Worth, Texas 76102
(817) 334-0066
mblum@theblumfirm.com
www.theblumfirm.com

MARVIN E. BLUM is an attorney and CPA based in Fort Worth. He is Board Certified in Estate Planning and Probate Law and is a Fellow of the American College of Trust and Estate Counsel.

Mr. Blum founded The Blum Firm, P.C., now in its 40th year. The Blum Firm is one of the premier estate planning firms in the nation, known for creating customized, cutting-edge estate plans for high-net-worth individuals. The firm specializes in estate and tax planning and the related specialties of asset protection, business planning, business succession planning, charitable planning, family legacy planning, fiduciary litigation, and guardianship.

Mr. Blum serves on the Editorial Advisory Committee for *Trusts & Estates* magazine. He is Treasurer for the Fort Worth Symphony and the Texas Cultural Trust. He is Secretary/ Treasurer of the Pat & Emmitt Smith Charities and a member of the Boards of Directors of the Multicultural Alliance and B Sharp Youth Music Program.

Mr. Blum earned both his BBA in Accounting (Highest Honors) and his law degree (High Honors) from the University of Texas.

Business Succession Planning Roadmap

1. Start the Process
 2. Create an Action List
 3. Form a Planning Team
 4. Manage Expectations
 5. Identify the Issues
 6. Define the Desired Outcome
 7. Search for a Solution
 8. Get Buy-In From Key Stakeholders
 9. Address the Challenges
 10. Implement the Solution

Statistics

- › 90% of American businesses are family-owned or controlled.
- › According to a recent article in *Trusts & Estates* magazine:
 - 30% of private business owners are over 67 years old and still actively running the business. Only 31% of them are working to educate and prepare family members to take over the business. Two-thirds lack a written succession plan. **In most cases, the families are unprepared for a sudden or unexpected event.**
- › Business Succession Planning is the **most neglected** area of estate planning.
- › Large family companies have combined annual revenues of more than \$9 trillion and directly employ around 30 million people.
 - This issue is not just for large or medium size firms. It's also critical for boutique and solo practices.
- › Only 27% of law firms have a succession plan in place.
 - 35% of equity partners are at or near retirement age. And, older lawyers are sticking around at a greater rate than we're adding younger lawyers. The average age of lawyers is increasing.
- › Who will take care of your clients when, not if, you're gone.
 - You need a plan. We all need a plan.

1) Start the Process

- › The planner needs to **be the instigator** (or the “irritant”) to help get the process started.
- › Watch for **psychological barriers**. Most founders aren’t wired to address long-term succession issues. They want to continue to go to work every day and grow the business.
 - Charles de Gaulle (former leader of France): “Cemeteries are full of indispensable people.”
- › **Expect denial**—expect that the founder hasn’t come to grips that he won’t be there one day.
- › This attitude leads to **planning paralysis**. It’s easier to just kick the can down the road than it is to get started on a business succession plan.
 - Scarlett O’Hara: “I’ll worry about that tomorrow.”

2) Create an Action List

- › Discuss where business succession fits into the overall estate planning process.
- › Make a list of all the tasks, and then prioritize them.
- › Put the tasks that are easiest to complete first. This **creates momentum**, and the client feels as though he's accomplishing something.
- › Business succession is usually the last step. If you did business succession first, you'd get bogged down and end up not getting other things done. We must keep the ball rolling so the client stays engaged and deals with this.

3) Form a Planning Team

- › Business succession isn't the kind of planning that involves just the patriarch and the lawyer like doing a Will. **It takes a team.** Who goes on the team is determined case by case. There's no set answer.
- › It's critical to include an advisor with a long-standing relationship with the family. This might be a lawyer, CPA, financial advisor, or life insurance professional. There needs to be someone on the team who the family trusts and who has a high degree of credibility with the family.
- › The latest trend is to also include an outside consultant. This is often a professional with psychology skills—sort of a family therapist, who understands behavioral issues and can handle all the family dynamics that are at play.
- › You need to decide who's going to be quarterback.

4) Manage Expectations

- › At this point in the process, before you embark on the legwork, it's important to manage expectations.
- › When it comes to business succession, there is no perfect solution. It'll likely be impossible to achieve perfect equality between children, and no one will get everything they want.
 - Don't confuse the concepts of what's "fair" with "equal." In this case, fair very likely won't be perfectly equal.
- › It's also important that everyone understands that putting a business succession plan in place is not a quick project. It's a process that evolves over time and includes multiple meetings.
- › It's impossible to predict how long it'll take at the outset, but it'll likely be months, not weeks, to get to the finish line.

5) Identify the Issues

- › We can't craft a solution until we know the problem, and no two situations are alike.
- › We want to identify who the key stakeholders are and interview them individually to learn their concerns and goals for the plan. Interviews are often conducted by a family business consultant (ideally with a psychological background).
 - Founder
 - Founder's spouse
 - Children
 - In-laws
 - Key employees

6) Define the Desired Outcome

- › Because no two succession plans will be identical, we need to remain flexible in the idea of what will mean success for each family.
- › There are some factors that are common within many effective succession plans:
 - The business is managed by people who have the right skill set.
 - The business generates cash flow for all of its owners.
 - There is an exit strategy in place for those who decide they want to get out.
 - The business is just a portion of each owner's overall financial picture.
- › Sometimes these factors are unattainable, and a sale of the business may be the best option. I know some business owners will want to stipulate that the business should never be sold, but **even the Rockefellers sold Rock Center.**

7) Search for a Solution

- › There are 3 primary choices in the toolbox when thinking about succession planning:
 - Transfer the business to a family member/family members.
 - Sell the business to people within the business.
 - Sell the business to an outside party.

- › Other aspects of the solution: If the children are going to keep the business and some are active in the business while others are not, explore how to create a cash flow for the children not active in the business. Are there assets that you can divide up and distribute out to the owners?

- › Also look to life insurance. Life insurance proceeds can provide cash to the children not active in the business.

- › Look to publicly-traded companies for options. In 2010, Warren Buffett revealed that he requires the managers of his Berkshire Hathaway companies to submit a succession plan and update it regularly. He sends his “all star” managers a memo every 2 years asking their recommendation as to “Who would take over tomorrow if you should become incapacitated tonight?”

Ownership Versus Management

- › The founder's estate plan determines who gets ownership of the company, but that's different from who will manage it. Owners should not automatically be the managers if it's not in their skill set.
- › Ownership Versus Governance—The business **needs to run like a business and not like a family.**
 - Who will establish policies and provide corporate governance?
 - Who will make up the Board of Directors?
 - Who will choose the Directors?
 - Consider different classes of stock. Some can vote for Directors; some can't. Or could leave the stock to a trust for the benefit of the family with a carefully-selected trustee who'll vote the stock.
- › Consider the timing—when the change in control of the business should happen. It's often best to transfer control while the founder is alive so that he can participate in the process and influence the stakeholders. The founder is the "glue" that keeps everyone together and makes the process a smoother transition.

- › Richard Rainwater, author of *Masters of our Time*: “What has always struck me as odd is that if you look at public corporations, even corporations that begin as family businesses, the way they promote people is based on skill, not bloodlines. But most families continue to make decisions on who will manage the fortune based on bloodlines.”

- › **Life insurance** can play an important role in the solution.
 - If there are children who will not be involved in the business, life insurance can provide a cash flow for them.
 - An Irrevocable Life Insurance Trust (“ILIT”) can be a source of liquidity to pay estate tax.
 - An ILIT can also be a source of liquidity to “equalize” inheritances.
 - Key man life insurance (with the company as the owner and beneficiary) can provide the business with liquidity to cushion the loss and help offset any costs of losing a founder or other key employee.

- › A **buy/sell arrangement** can be crucial to the success of a succession plan.

Buy/Sell Agreements

- › Written agreement in which each owner of a business agrees that, upon occurrence of a triggering event, such as death, disability or retirement, his ownership interest in the business will be sold to the other parties.
- › If the buy/sell agreement sets a specific sales price rather than a formula, you'll want to get an appraisal every 3 years and update the buy/sell agreement.
- › Sometimes family businesses and family members create buy/sell arrangements so that the ones in the business can buy out the ones not in the business after a death. The non-active sibling sells and gets cash. The active sibling buys and gets control.

- › **Entity Purchase Buy/Sell Agreement** (also called a Company Redemption)
 - The company buys the owner's share upon a triggering event.
 - If the company is a corporation, it's often called a Stock Redemption Agreement.
 - If the company is a partnership, it's often called a Liquidation of Interest.
 - If life or disability insurance is used to fund the buy/sell agreement, the company holds insurance on each owner and uses the proceeds to purchase the deceased or disabled owner's share.
 - When the company buys an owner's share, the ownership percentages of the other owners' interests increases but the basis remains the same.
 - Be sure to coordinate the buy/sell agreement with the existing governing documents for the entity. For example, an LLC company agreement might include right of first refusal provisions.

› **Cross Purchase Buy/Sell Agreement**

- Owners A, B, and C agree to buy out each other's share upon a triggering event (instead of the company being the buyer).
- Life insurance is often used to fund a Cross Purchase Agreement. Owner A owns policies on Owners B and C. Owner B owns policies on Owners A and C. Owner C owns policies on Owners A and B. Premiums can be paid with their own money or with bonuses from the company.
- An income tax advantage of this type of Buy/Sell Agreement is that the survivor's basis in the interest acquired is increased by the price paid.
- Note that although the lower premiums of term life insurance can be more attractive, term rates can often become very costly to renew past the initial term limit. The upfront costs of permanent life insurance may end up being a smarter financial move in the long run.

› Tax Differences of Buy/Sell Agreement Types

- The different types of buy/sell arrangements can have drastically different tax impacts for a surviving partner in the future.
- Example with **Entity Purchase**: Shareholders A and B each hold 50% of the shares. Their basis is \$10,000, respectively. Shareholder A dies, and the corporation buys back all of Shareholder A's shares for \$200,000. Now Shareholder B owns 100% of the shares. When Shareholder B later decides to sell the company for \$400,000, he will have \$390,000 of gain because his basis remains at \$10,000.
- Example with **Cross Purchase**: Shareholders A and B each hold 50% of the shares. Their basis is \$10,000, respectively. Shareholder A dies, and Shareholder B uses life insurance proceeds to buy Shareholder A's shares for \$200,000. When Shareholder B later sells the corporation for \$400,000, he will have \$190,000 of gain because his basis increased to \$210,000 upon his purchase of Shareholder A's shares.

Back to our Search for a Solution

- › We need to recognize when selling the business is the best solution. The patriarch may have psychological barriers to selling the family business.
- › Selling the business during the founder's lifetime is much better than waiting to sell it right after the founder dies.
 - The founder is better able to articulate the opportunities for the business going forward than the heirs are.
 - The heirs don't speak with one voice.
 - Time of bereavement isn't the best time to do this.
- › You want to choose the best time to sell and not be under pressure to sell at the time the founder dies and you're under the gun. (For example, a fire sale to pay estate tax). The timing of the sale is a strategic decision you want to be in control of.

Pre-Sale Planning

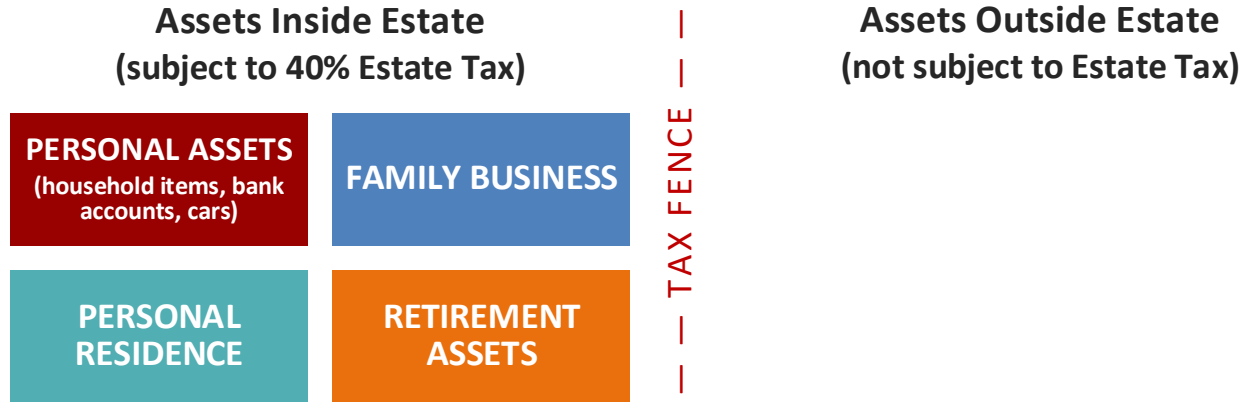
- › Before selling, you'll want to look for inefficiencies in the business and remedy them to **maximize the sale price**. Reduce overhead, shore up the management team, etc.
- › The second part of this pre-sale analysis is **minimizing taxes**. Estate planning before the sale ("squeeze and freeze" planning) can reduce the amount of estate tax and, therefore, maximize the proceeds that the family gets to keep. You'll want to build into the plan for the wealth to pass down from generation to generation free of estate tax.
- › Do the estate planning at a time when assets can qualify for the maximum amount of valuation discounts. The earlier in the timeline, the better.
- › With careful drafting, it's even possible for the founder to move the business out of the estate but continue to stay in control and have access to the assets for his needs.

A Tale of 2 Families

Family 1: The Baade Family

- › Donny and Marie Baade own a business that has grown from \$30 million to be worth \$50 million along with \$4 million of other assets (home, bank accounts, cars, and other personal assets).
- › They did “basic” estate planning and have Wills dictating that the ownership of the business will pass to their 3 children. The plan is that their oldest son will run the business and buy out the other 2 kids.
- › They die and their estates owe \$12.3 million in estate tax. [\$54M – \$23.16M exemptions, 40% tax]
- › The kids don’t have \$12.3 million in liquid funds lying around, readily available and resort to a “fire sale” to quickly sell off the business to be able to pay the tax bill due nine months from death.

BAADE ESTATE



Estate Tax = \$12.3 million

- › Why didn't they move the family business out of their taxable estates? Common reasons are:
 - They had a basic estate plan in place and thought they had done what was needed. They'd checked estate planning off their "to do" list.
 - They were under the misconception that in order to move the business out of their estate, they would have to lose access to or control of it.
 - They thought the cost for sophisticated tax planning to move the business out of their taxable estate would be too high.

Family 2: The Goode Family

- › William and Anna Goode have a similar situation as the Baades. They also own a family business that has grown from \$30 million to now be worth \$50 million and own \$4 million of other assets (home, bank accounts, cars, and other personal assets). They also plan to leave ownership of the business to their 3 children. The oldest son plans to run the business and one day buy out his siblings.
- › Back when the business was worth \$30 million, they engaged in business succession tax planning.

The “Squeeze”

- › William and Anna Goode first engaged in planning to “squeeze” down the value of the business to be able to move as much as possible out of their estates.
- › They examined the entity structure and created a structure that would qualify for the best possible valuation discount.
 - If an LLC or limited partnership, examine the agreement to ensure that the entity will qualify for an optimum valuation discount.
 - If a C Corporation, transfer stock to a limited partnership.
 - If an S Corporation, reorganize the structure to establish 1% voting and 99% non-voting shares. Perform tax planning with the non-voting shares, which qualify for a valuation discount.
 - For William and Anna, they created a limited partnership to own their business.

The “Freeze”

- › There are several techniques available to move the assets out of your estate and “freeze” the value of the estate, and they can be used in any combination of gifts and sales.
 - Gifts/sales to a Defective Grantor Trust (“DGT”) for the benefit of your children.
 - Gifts/sales to a Spousal Lifetime Access Trust (“SLAT”) for the benefit of your spouse.
 - Sales to a 678 Trust (also called a Beneficiary Defective Trust or “BDT”) for the benefit of you and your family.

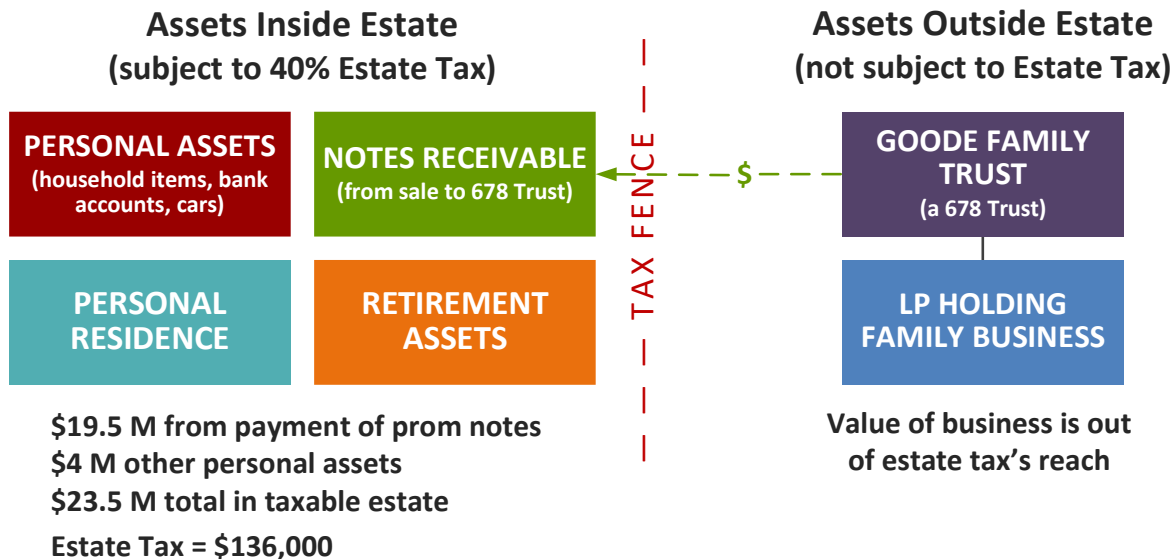
- › William and Anna Goode choose a 678 Trust because they want to continue to be able to benefit from the assets held in the limited partnership. A 678 Trust is a unique vehicle that saves estate tax and protects assets from creditors, yet you can:
 - Stay in **control** of the assets;
 - Continue to have **access** to the assets for your needs; and
 - Retain **flexibility** to alter the plan if you later change your mind on where/when/how you want the assets to pass.

- › Because the 678 Trust (the “Goode Family Trust”) is created by a third-party trustor, William and Anna can be beneficiaries of the trust. As beneficiaries, they can receive distributions for health, education, maintenance, and support.
- › The limited partnership interests, assuming valuation discounts of 35% for lack of marketability and lack of control, have a total value of \$19.5 million. [\$30M less 35%]
- › William and Anna each sold their 50% limited partnership interest to the Family Trust for \$9.75 million in exchange for promissory notes.
- › William and Anna will use the note payments they receive to cover their living expenses and income taxes, “burning” down their taxable estates over time.

After Squeeze and Freeze Planning

- › The Family Trust will make principal and interest payments on the promissory notes payable to William and Anna.
- › William and Anna have not lost access to the business's profits. In addition to note payments, the Family Trust can make distributions to them as needed for their health, education, maintenance, or support.
- › Once William and Anna sell the family business to their oldest son, the \$50 million proceeds go into the limited partnership. The Family Trust uses the proceeds to pay off the promissory notes (\$9.75 million each). The rest of the proceeds (\$30.5 million) remain in the partnership, available to William and Anna but protected in the Family Trust.
- › At William's and Anna's deaths, their estates owe \$136,000 in estate tax, assuming there's been no burn down of the notes yet. [\$4M + \$9.75M + \$9.75M less both \$11.58M exemptions, taxed at 40%]

GOODE ESTATE



- › If the business had grown to \$60 million or \$70 million, instead of \$50 million, the estate tax bill would have been the same. Their taxable estate was frozen at the squeezed promissory note amounts.

8) Get Buy-In From Key Stakeholders

- › After determining the solution, the next step in this process is to get buy-in from everyone. First, we want the founder's buy-in. Remember, he's the "glue."
- › Next, we turn to the rest of the stakeholders. Conduct a "family meeting" with all the family members. Having everyone's support not only makes the planning process smoother but also increases the likelihood that the plan will ultimately be successful. It's best to have an independent party facilitating the family meeting, ideally someone with a family consulting background.
- › We can't address business succession planning without also addressing family dynamics.
 - If the family governance system is weak and there's poor communication and lack of trust, the business will suffer.
 - **Business succession planning and family governance planning go hand in hand.**

Family Advancement Sustainability Trust (“FAST”)

- › Consider creating a trust to endow the cost of conducting regular family meetings and family enrichment activities.
- › A Family Advancement Sustainability Trust (“FAST”) is the best way to pay for family meetings and other best practices of successful multigenerational families, such as:
 - Holding family meetings and family retreats;
 - Creating a curriculum and educating future heirs to become responsible inheritors;
 - Establishing a system of family governance; and
 - Working to preserve the family’s history and heritage.

› **A FAST provides FUNDS:**

- Funds for future generations to use to prepare heirs to be able to successfully manage an inheritance.
- Fund family endeavors to keep the family together after the elder generation dies, such as family retreats and family meetings.
- Funds to train future generations on concepts like philanthropy and being responsible stewards.

› **A FAST provides LEADERSHIP:**

- Creates a leadership structure to ensure these activities happen, using a system of trustees and committees who are paid to run the FAST and charged with the responsibility for carrying out these tasks.

9) Address the Challenges

- › There are two specific challenges that are very common, so you'll want to be ready for them.
- › The first inevitable obstacle is the **founder's fears**.
 - Some clients worry that their lives will be empty and boring or that they will no longer be welcome at the office. They worry about what they will do with their time.
 - Address the question of the role the founder will play in the business. It's better to shift day-to-day management responsibility to a successor management team. Will the founder be a director (helping establish policy/broad oversight)? Will he work on special projects? Note that a prospective buyer would consider it a valuable plus if there's a successor management team in place running the day-to-day.

- A popular option is for the founder to open a family office to be responsible for philanthropy and investing and things outside of the family business. This provides a transitional environment for the founder to not feel as though their skills are no longer needed.
 - Don't fail to address any fears the founder's spouse may have—fears about how HER life will be impacted, especially if the founder is hanging around the house. **“I married him for breakfast and dinner, not for lunch.”**
- › The second obstacle that you'll inevitably face is **family conflict**.
- Family members often have conflicting goals and visions for the future of the family business, and so there will be some disagreement.
 - Diminish the intensity of conflict by ensuring that everyone's voice is being heard.
 - Focus on the positives and identify commonalities—the values that everyone shares—to get them to come together to work toward a solution.

10) Implement the Solution

- › The final step in this planning process is to implement the solution. This step may seem pretty straightforward, but it's important to understand that implementing the plan may be a multi-year process.
- › If the solution is to keep the business in the family, you **start training the successor.**
 - Invite to observe board meetings and management meetings.
 - Consider creating a "junior board." This might influence what they choose to study.
 - "Ride around in the truck" with the founder.

- › Don't overlook the females in the family. Statistics show that females fare extremely well in taking over a family business. According to a Merrill Lynch study:
 - Women make more values-based decisions rather than just going for the bottom line. They see money as more than a way to finance the life they want to live but also as a way to meet commitments to themselves and to people and issues they care about.
 - Women live, on average, five years longer than men. Women may be around longer to run the business.
 - Women graduate in higher numbers from college and graduate school today than men (57% of recent graduates).
 - 42% of women ages 18-64 have a bachelor's degree or higher.
 - A mother typically spends a lot of energy maintaining the emotional cohesiveness of a family and keeping the peace among family members. This mindset can be a positive force in a business.

Learn From Other Families

Feil Family of New York – A Succession Plan That Failed

- › Louis Feil was a real estate mogul and created a dynasty reported to be worth \$7 billion. Patriarch Louis died in 1999, matriarch Gertrude in 2006. The family business passed to the 4 kids (1 son and 3 daughters) in equal shares.
- › The only son, Jeffrey, was groomed to take over. Jeffrey controlled the cash flow and distributed just \$300,000 each year to each of the 4 kids. He reserved the majority of the business's cash to buy up more deals.
- › Jeffrey was paid a salary which provided him with a cash flow. For the 3 sisters, their only cash flow from the family business was what Jeffrey chose to distribute.

- › The 3 sisters took Jeffrey to court, alleging that he was starving them out so that he could buy them out at a discounted price. One sister had a terminal illness and expressed concern that her family will be unable to pay their estate tax.
- › The family lost its glue when the parents died. Jeffrey was quoted as saying that when his father died, **“The binding of the book came loose,”** and then when his mother died, **“The pages fell out.”**
- › A better succession plan could have provided cash flow for all the business owners, such as with life insurance. Or, sell some assets and make cash distributions to all 4 kids. The way Louis Feil set it up is a recipe for disaster.

Johnson & Johnson – A Succession Plan That Works

- › Johnson & Johnson was started by 3 Johnson brothers in 1886 as a manufacturer of surgical dressings. The company attributes part of its survival to the successful implementation of succession planning programs.
- › One of their programs grooms future leaders for the company. A selection committee identifies employees who have the potential to be future leaders.
- › The selection committee presents them to the CEO and a corporate governance committee for review. The CEO and this governance committee pick the candidates.
- › These future leaders have career paths mapped out for them and are provided continuous training including general management training programs and individualized training for their specific business sector.

- › There are two sets of candidates. One set is employees selected for top management positions. The other set is called “change drivers” who go through a different curriculum. The change drivers aren’t trained for a specific department but are trained for the entire operations of the company.
- › The result is that there are smooth leadership transitions within the company. Over the years, half of the company’s CEOs have come from within the company.

Pac Paper, Inc. – Decided Best Solution Was to Sell

- › Pac Paper, Inc. in Vancouver, Washington was started by David Morgan's father over 40 years ago. They manufacture paper sleeves for coffee cups and other paper products.
- › David was receiving calls from competitors wanting to buy the company. At the time, he had no plans of selling the company away from the family.
- › Those calls from buyers started him thinking about the future of the company and who would run it after him. He realized that the next generation wasn't in a position to take over leading the business. And, he knew that good offers wouldn't stay on the table forever.
- › So he and the other co-owners agreed to sell the family business to a rival company. Even though the business had been in the family over 40 years and David couldn't imagine that it would no longer be in the family, or that he would be the one to sell it, he knew that a sale was the best way to keep family unity going forward.

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777 Main Street, Suite 550
Fort Worth, Texas 76102
(817) 334-0066

300 Crescent Court, Suite 1350
Dallas, Texas 75201
(214) 751-2130

303 Colorado Street, Suite 2550
Austin, Texas 78701
(512) 579-4060

2800 Post Oak Blvd., Suite 4100
Houston, Texas 77056
(713) 489-7270