

# Transition by Design: Successful Succession of the Privately Held Business

Estate Planning Council  
of Seattle

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# Business Succession Planning. . . and Yogi Berra

“It's like déjà vu all over again!”

- New “what ifs” on a fairly consistent basis
- NAEPC past president Jordon Rosen's article in NAEPC Journal of Estate and Tax Planning
- September 8, 2016
- Better to wait and see?

“When you come to a fork in the road – take it!”

- Plan – No matter which turn is taken, the path is clear
- Static documents interpreted in light of dynamic new law
- FLEXIBILITY
- Disinherit spouse or other beneficiaries?

“If you don't know where you're going, you wind up somewhere else.”

- Wealth in motion will be taxed!
- Income tax and basis planning – The New Black
- Capital gains tax
- State tax regimes

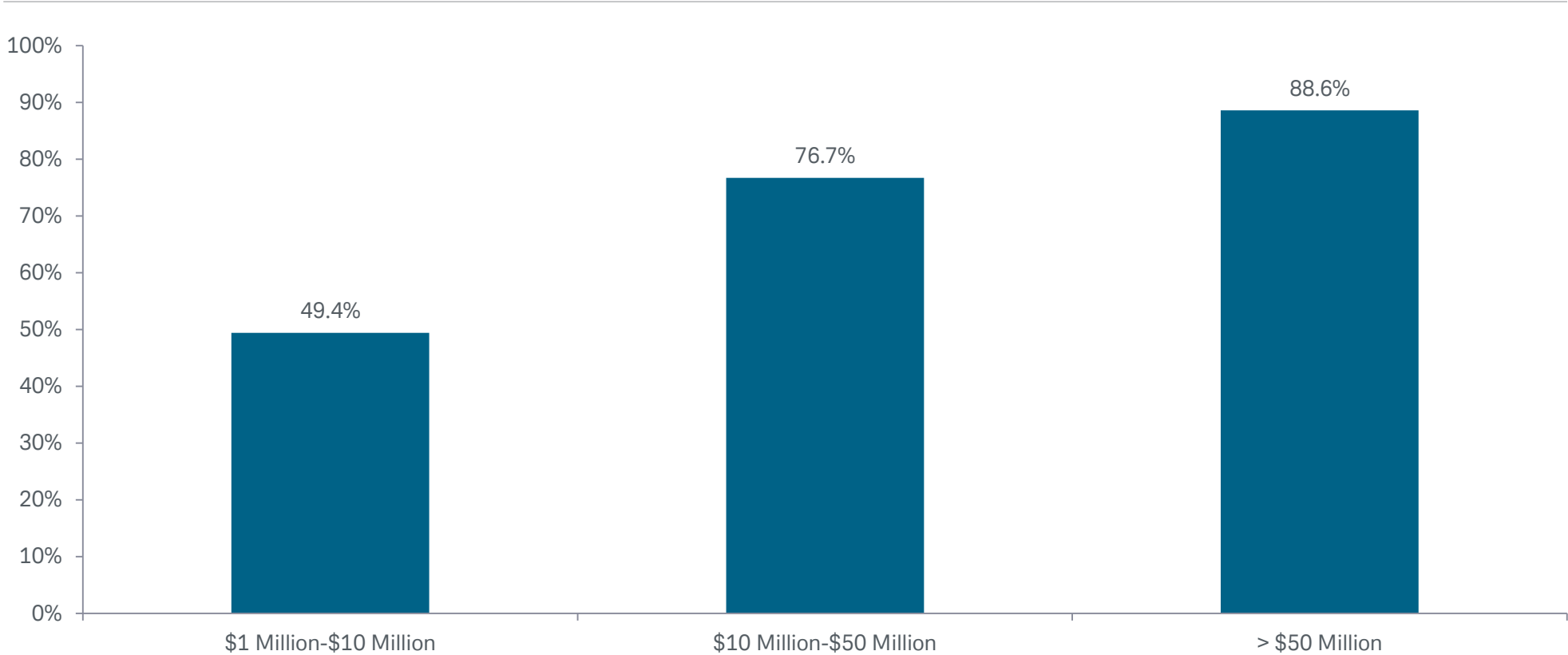
Source: USA Today – 50 greatest Yogi Berra quotes

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# A Changing Marketplace and Business Owner Demographics

# Wealth Creation in the United States

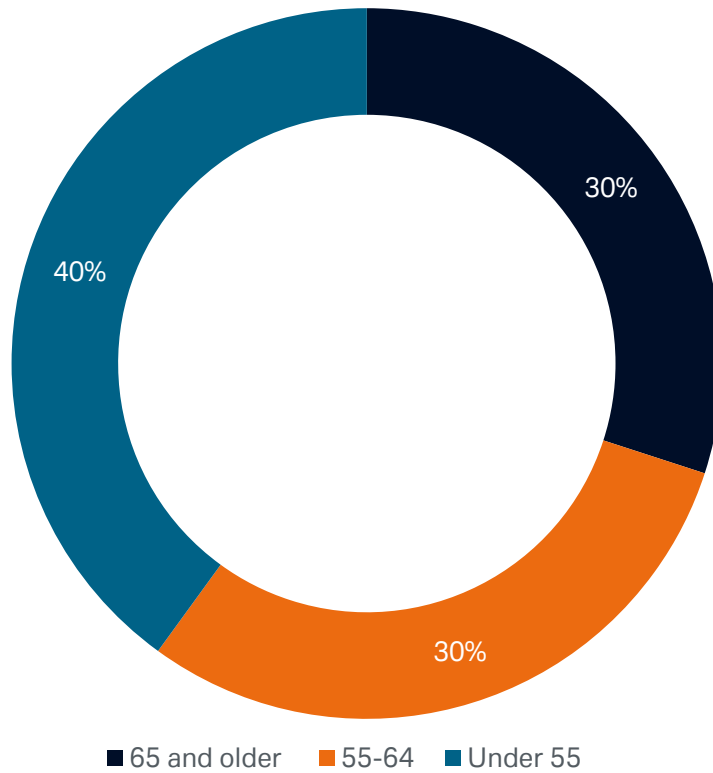
Percentage of Millionaire Households That Own a Private Business by Net Worth Tier<sup>1</sup>



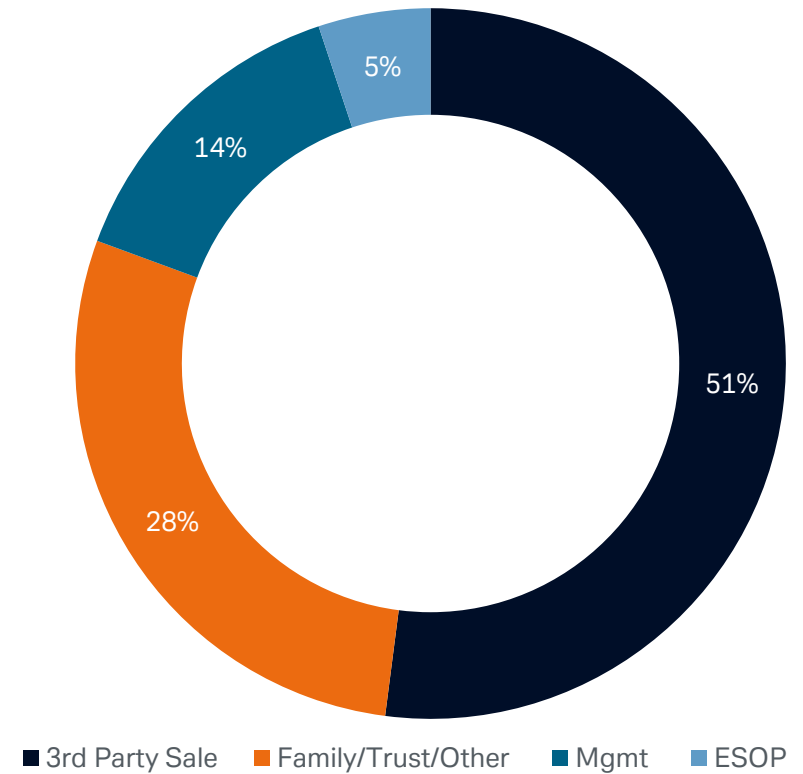
<sup>1</sup> Federal Reserve 2013 Survey of Consumer Finances. Shows a 1.6% decrease overall in Holdings of Business Equity Across Tiers since 2005.

# Winds of Change

Business Owner Age



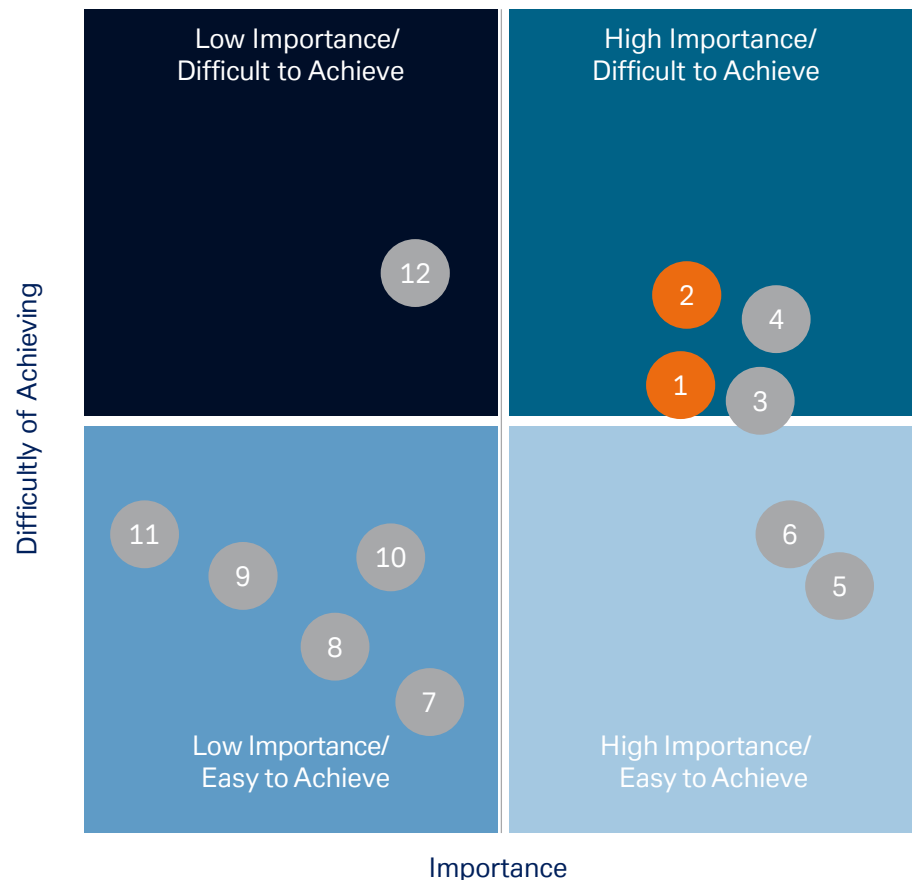
Ownership Transition



Source: New York Times "Are Baby Boomers Ready to Retire?" February 11, 2011.

Source: VIP Forum 2010 Survey of Business Owners

# Mission Critical Issues of Greatest Importance and Difficulty for Family Businesses



- ① Resolving conflicts among family members who are in the business
- ② Formulating a succession plan
- ③ Developing a strategic plan
- ④ Developing a retirement and estate plan
- ⑤ Ensuring that the family's core business values are maintained
- ⑥ Financial growth plan
- ⑦ Compensating family members in the business
- ⑧ Bringing family members into the business
- ⑨ Ensuring family members benefit from owning shares
- ⑩ Bringing non-family executives into the business
- ⑪ Transferring wealth and equity to family members not involved in the business
- ⑫ Transferring wealth outside the business

Source: Grant Thornton, *Results of Family Business Survey*

# Challenges Facing Family Businesses

- 85% of the crises faced by the family business is focused around the issues of succession.<sup>1</sup>
- According to the Small Business Association:<sup>2</sup>
  - 90% of America's businesses are family owned
  - 30% make it to 2<sup>nd</sup> generation
  - 12% survive to 3<sup>rd</sup>
  - 3% reach the 4<sup>th</sup>
- Primary reason is failure to properly structure a succession plan<sup>3</sup>
  - 90% agree on importance of exit planning
  - 33% have a business succession plan
  - Only 29% feel their team of advisors is qualified to help

<sup>1</sup> Keeping it in the Family: Business Succession Planning; Charles D. Fox IV; A.L.I.-A.B.A. (2011)

<sup>2</sup> Challenges in Managing a Family Owned Business; Small Business Administration (SBA.gov).

<sup>3</sup> VIP Forum 2012 Survey of Small Business Owners



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# Integrated Master Plan Design

The Process Driven Strategic Model and  
Strategic Assessment

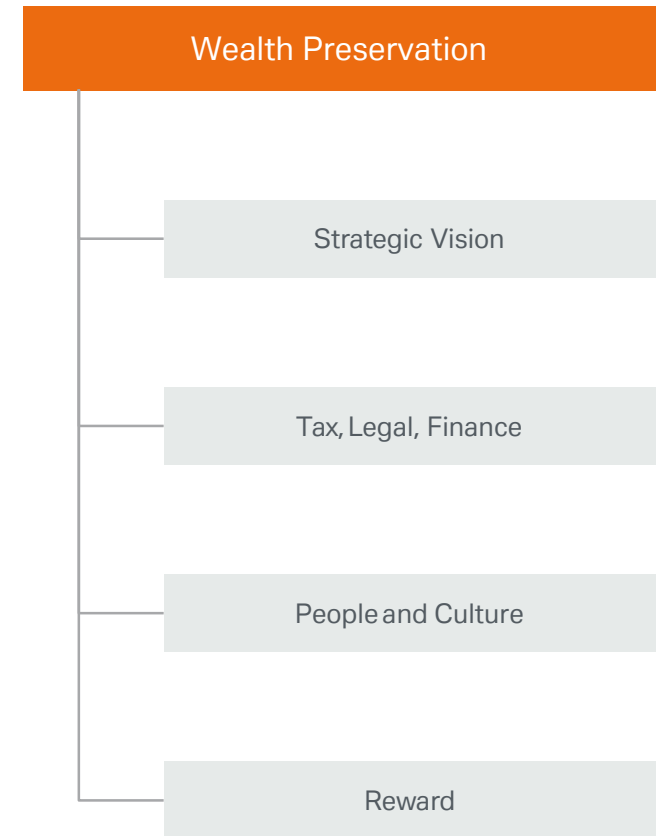
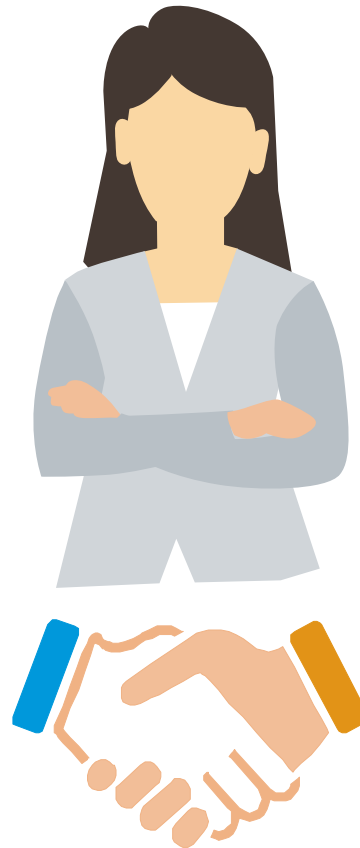
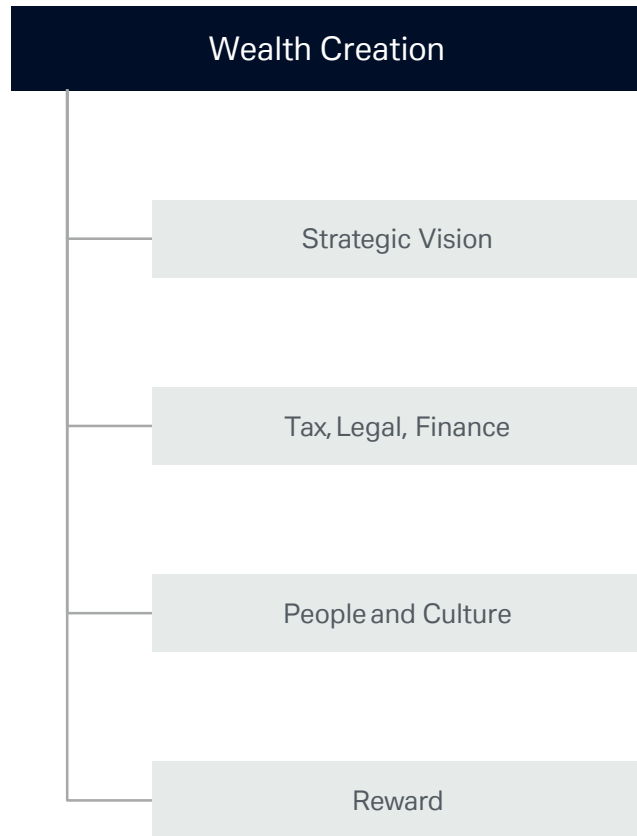
# Transition by default can be a real juggling act. . .



# ...with serious consequences



# The Drivers – Business and Family Dynamics

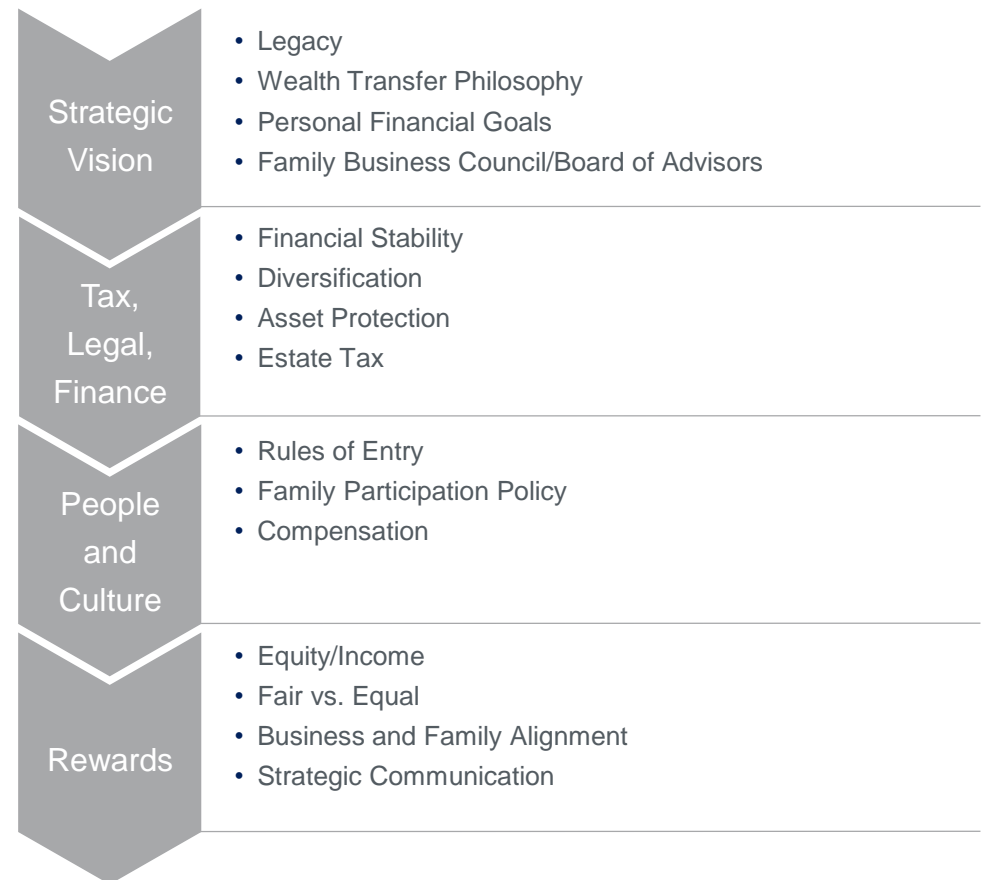


# Strategic Assessment

## Business – Wealth Creation

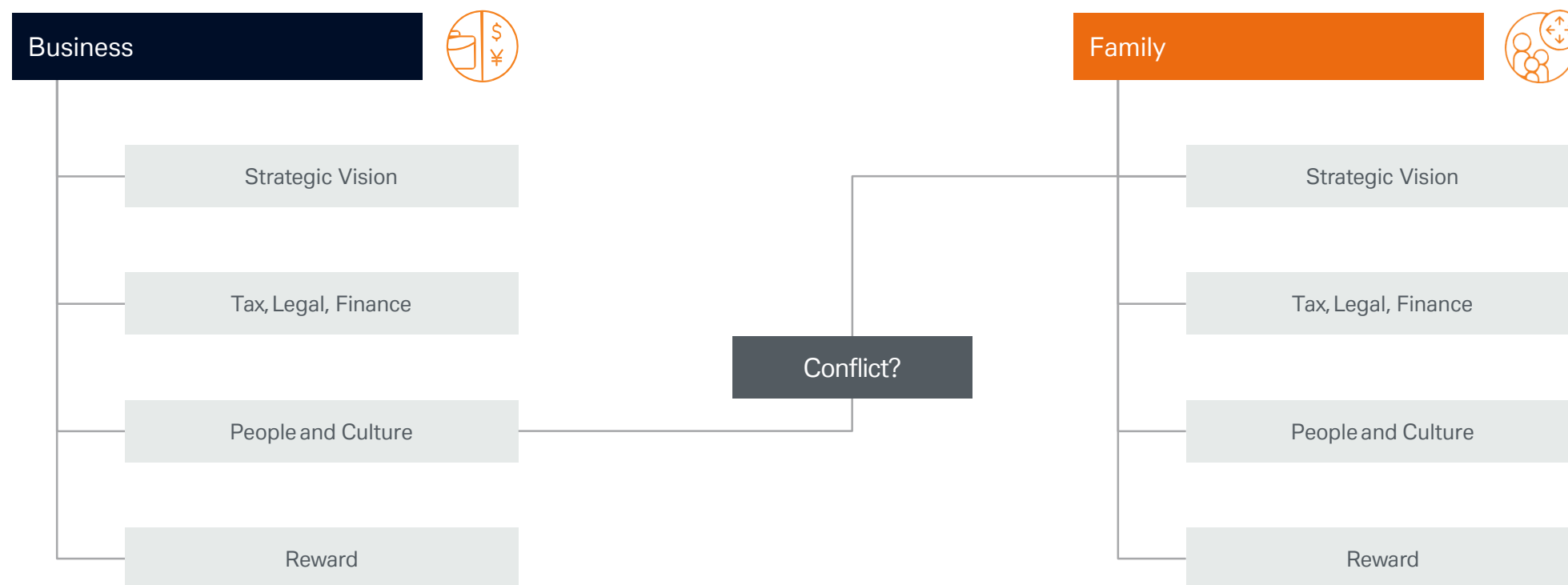


## Family – Wealth Preservation



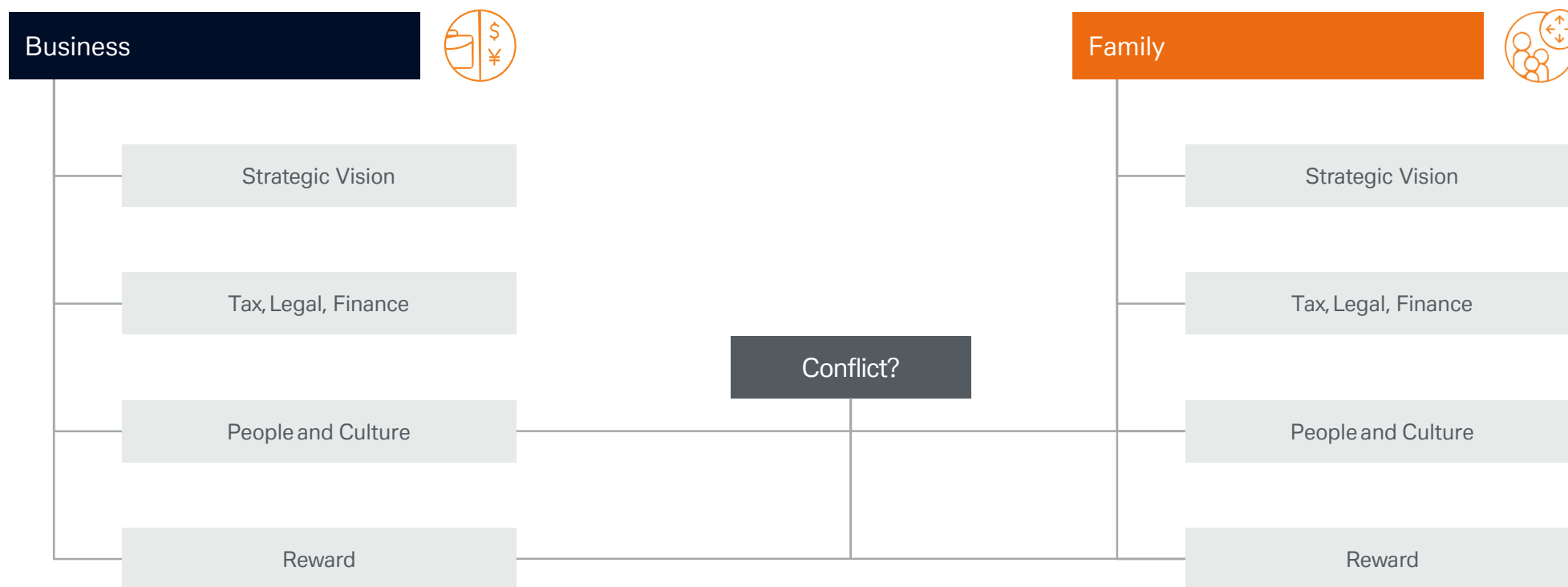
# Final Phase: Resolve Conflicting Objectives – 1

- The owner of a family business envisions naming his son CEO.
- The CFO—a critical employee and NOT a family member—neither likes nor respects the son.
- In fact, the CFO, and others, will likely quit if the son is named CEO.



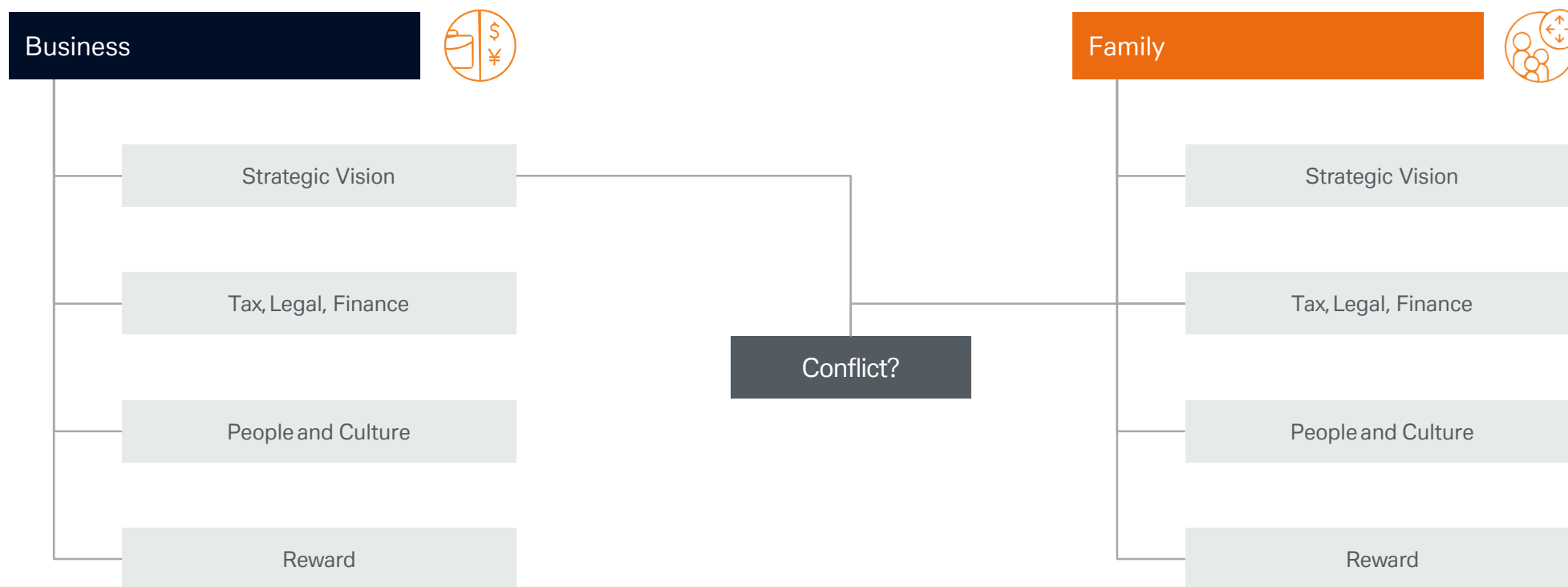
# Final Phase: Resolve Conflicting Objectives – 2

- Kids in the family paid birthright v. market rate
- Non-family members know that family employees are being overpaid – they see cars, neighborhood, vacation, etc.



# Final Phase: Resolve Conflicting Objectives – 3

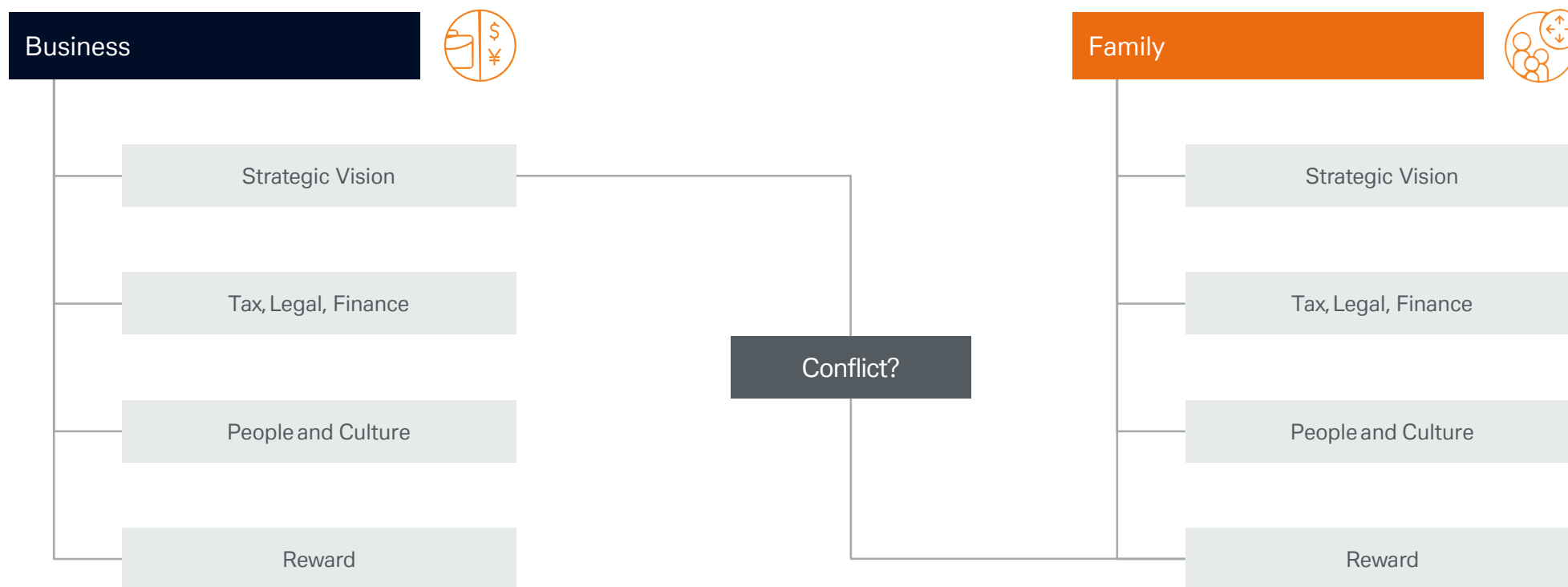
- Business owner has a vision of growing the business but wants to retire soon.
- Growth will take cash
- Owner has liquidity needs at retirement.





# Final Phase: Resolve Conflicting Objectives – 4

- Inactive family shareholders in business are frustrated with active family members being paid huge salary and receiving company car, while the inactives get low or no dividend
- Active kids say, "you are getting a free ride on my equity!"



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# Strategic Opportunities

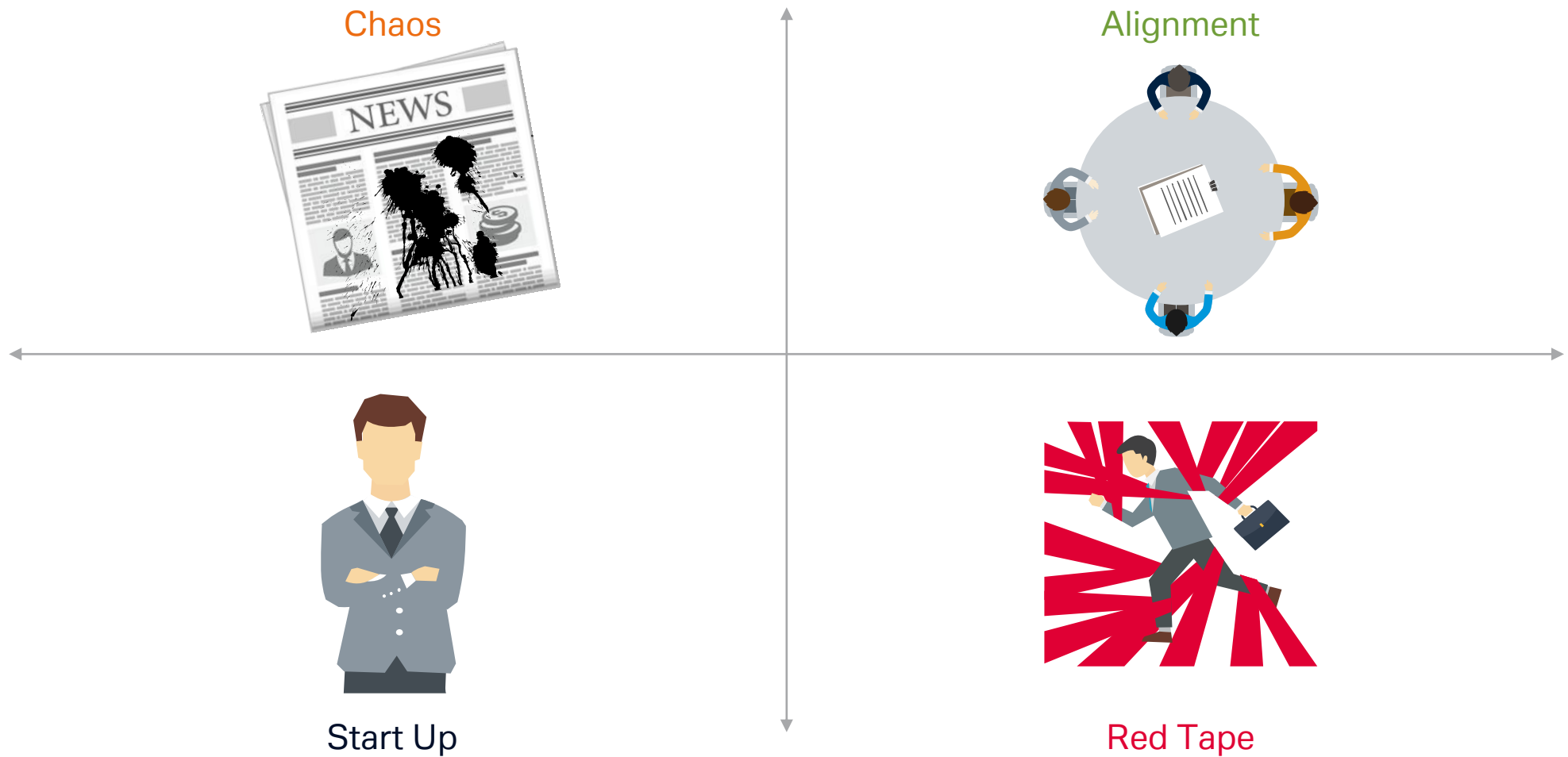
# Know Your Numbers

## Prevailing Factors

## Amounts/Rates

Valuation Options	Strategic-Financial-Estate
Long-Term Capital Gain Rate	20%
Qualified Dividend Rate	20%
Top Income Tax Rate	37%
Annual Gift Exclusion	\$15,000 individual/\$30,000 married ("Use it or lose it")
Lifetime/Death/GST Exemption	\$11,400,000 individual/\$22,800,000 married (portable)
Top Transfer Tax Burden	40%
Additional Tax Burden	\$66,000/month (per \$20 million Taxable Estate @7.2%)
Applicable Federal Rate (AFR)	Low by historical standards
September 2019 Rates	AFR Short – 1.85%; Mid – 1.78%; Long – 2.21% & 7520 – 2.2%
Medicare Surcharge	3.8%

# Evolution of a Business. . . .or De-evolution?



# Strategic Opportunities: All In The Family

- **Create Financial Stability**
  - Take some chips off the table
  - Tax-free dividends
  - Diversify
- **Prepare for Management Succession**
  - Identify and groom an heir apparent
  - Design incentive to attract/retain/reward top talent
- **Establish Private Business Governance Model**
  - Family Business Council
  - Board of Advisors
  - Dividend policy

# Strategic Opportunities: All In The Family

- **Classic Freeze**
  - Valuation discounts
  - Low AFR cycle
  - The “No Plan” plan can result in additional \$66,000/month in estate taxes<sup>1</sup>!
- **Consolidate Ownership**
  - Buy out non-optimal shareholders
  - 3.8% Medicare surcharge
  - Low capital gains

<sup>1</sup> For illustrative purposes only.

# Strategic Opportunities: Sale to Third Party

- **Wear Hat of Buyer**
  - Curb appeal
  - Assess drivers
  - Talented and likeable managers
  - Audited financials
- **State of the Market**
  - Frothy?
  - “Private equity firms now have more than \$1 trillion of available capital. Expect more deals at higher prices.” – Fortune.com

# Strategic Opportunities: Sale to Third Party

- **What's It Worth?**

- Strategic vs. financial buyers
- EBITDA vs. adjusted EBIDTA
- Multiplier
  - Industry specific
  - Growth prospects
  - Firm size
  - Established financial history
  - Earnings stability/volatility
  - Top talent in place
  - Owner participation
  - Concentrations
  - Unique vs generic product/service

- **Strategic Positioning**

- “It’s not what you get – it’s what you keep
- Long-term capital gain rate still low (20%).
- Core Assets – Real Estate – Cash



# Strategic Opportunities: The Rest of the Story

- **Other Options**

- Internal management buy-out
- ESOP
- IPO

- **Polishing the Apple**

- Knowledge is power!
- Manage as a dual track process
  - Plan A as chosen with
  - Back-up Plan B
- Analyze value, cash flow, liquidity and risk

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# Changing Paradigms

# Valuation Planning

## The Old Paradigm

“I know what my business is worth based on the offers I get.”

# Valuation Planning

## The Old Paradigm

“I know what my business is worth based on the offers I get.”

## The New Paradigm

“Valuation is an art . . . and a science.”

- Strategic                      \$30 million
  - Financial                      \$25 million
  - Estate                         \$18 million
- 
- Purpose driven
  - Preserve confidentiality

# Family Business vs. Family Wealth

## The Old Paradigm

“My grandparents started this business and I am keeping it for my kids and grandkids.”

# Family Business vs. Family Wealth

## The Old Paradigm

“My grandparents started this business and I am keeping it for my kids and grandkids.”

## The New Paradigm

“The business world is more complicated than it used to be. My family wants to do something else.”

- Control of family wealth is more critical than control of family business
- Opportunity cost. Would you buy your business at the same price?

# Static Documents vs. Dynamic Objectives

## The Old Paradigm

“I own my business 100%, so no need for employment agreement, incentive plan or shareholder’s agreement.”

# Static Documents vs. Dynamic Objectives

## The Old Paradigm

“I own my business 100%, so no need for employment agreement, incentive plan or shareholder’s agreement.”

## The New Paradigm

“I have to strategically position the business and wealth. Protect the business, my family and employees.”

- Keep
  - Death, disability and retirement
  - Ownership and management continuity
  - Establish rules of entry and family business governance
  - Market rate vs. birthright
- Transition to third party
  - Position/protect A-team players
  - Conflicting documents



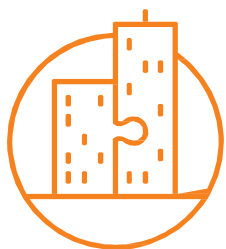
# Strategic Positioning – Next Steps

- Put Team together
  - AEP® is collaboration designation!
- Understand your options
- Learn where business and family goals are at cross-purpose—and align
- Establish legacy for future generations
- Plan and fund away the estate tax obligation

# Freedom of Choice

More dollars to

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Your Businesses



Your Family



Your Community



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