

## **STRATEGIES FOR SUCCESSION**

### **Keeping A Family Business In The Family**

Any business owner who has children or grandchildren who wish to participate in the business in the future is faced with the necessity of planning for succession. Many of the factors involved in planning for succession are personal. Issues like how much retirement income will the owner and his spouse require after ownership has been transferred must be addressed. Also the business owner must consider how to equitably treat descendants who do not wish to be involved in the business. Will there be sufficient liquidity in the owner's estate or his spouse's estate so that estate taxes will not diminish the value of the business or interrupt its operations?

However, a significant part of the planning process relates to tax strategies and estate planning. Failure to plan could result in excessive estate taxes and the need to sell essential assets or the entire business, possibly under duress and at a discounted value. Also the business owner may not have adequately planned for his retirement if a succession plan is not in place.

### **Gifts**

Gifts are one of the more common ways to transfer equity from one generation to another. Gifts of up to \$10,000 per donee in each year are not taxable. Accordingly, a husband and wife can give up to \$20,000 per donee annually. This annual exclusion is now inflation adjusted, but remains at \$10,000 for 1999. Amounts in excess of these exclusions are taxable as a part of the unified federal estate and gift tax structure. at the same rate as federal estate taxes. The Federal estate tax rates begin at 37% for estates in excess of the \$650,000 unified credit equivalent, increasing to over 50% for estates exceeding \$2,500,000. The unified credit exemption is scheduled to increase gradually to \$1,000,000 by 2006.

Spouses may, however, transfer an unlimited amount of assets without any gift or estate tax liability.

When an individual transfers assets to a grandchild an additional tax is imposed, called the GSTT or "Generation Skipping Transfer Tax." The GSTT is applied at the 50% rate. However, there is an exemption which permits an individual to up to \$1,000,000 free of the GSTT. Since the GSTT is added to the gift and estate taxes, gifts to grandchildren can be costly from a tax basis.

### **Business Valuations**

Since the IRS imposes stiff penalties for undervaluing assets, any plan to transfer assets should include a business valuation. McGill, Power, Bell & Associates has performed many formal valuations. We have prepared an article, called "So You Want to Know What Your Business is Worth," which describes the techniques applied to business valuations. The IRS virtually requires that valuations be made prior to any sort of potentially taxable distribution of equity. Copies of this article are available on request. Valuations require a

company may be reduced by a varying amount, which can be as much as 30% or more for "lack of marketability" and another varying amount, which can be as much as 30% or more if it represents a minority interest.

To maximize the available discounts, corporations can have "voting" and "non-voting" stock. If the company is recapitalized with both kinds of stock, the non-voting stock can be transferred with a greater discounting of its value.

### **Various Strategies**

Perhaps the most common strategy is an Outright Gift. The donor may make tax exempt gifts of up to \$10,000 per year and use the \$650,000 exclusion. A married couple may make gifts of \$20,000 per year up to \$1,200,000, even if the assets gifted belong only to one spouse. When an asset is gifted its basis will remain the same as the basis of the donor, so the recipient would have to pay capital gains taxes on the sale at the old basis. If the assets were transferred through an estate the recipient receives a new basis. However, if the recipient does not plan to sell the assets in the foreseeable future, gifting is usually still preferable to inheritance. In addition to removing the future appreciation and income from the donor's estate, as it removes the future appreciation and income from the donor's estate.

The donor may make a Gift to a Grantor Trust. If the gift is made to a Grantor Trust, the donor may pay income tax on the income to the trust, even though the income is retained in the trust. The payment of taxes is not considered a gift, so this strategy enables a donor to increase the amount that he can give that is not subject to gift tax.

Another vehicle that can be used is a Grantor Retained Annuity Trust. All or part of a business is transferred to a trust in which the Grantor retains an annuity interest for a period of years, at the end of which the principal balance is distributed to the beneficiaries of the trust. The distribution is considered taxable as a gift, but the retained annuity causes its value to be reduced. For gift tax purposes the value is the total value of the property less the present value of the retained annuity. The present value of the annuity will be the annuity amount, the number of years it will be received, and a current interest rate.

Another strategy is an Installment Sale. This strategy is particularly effective for rapidly growing businesses. The value of the business can be "frozen" in an installment sale, as it is calculated at the time of the sale. The owner reports capital gain and interest income, but any appreciation after the sale is not included in the owner's estate. A variation of this strategy is a Self Canceling Installment Note, which means that the installment obligation expires with the seller's death. To qualify, the buyer must pay a premium either in the sales price or interest rates.

Creation of a Private Annuity provides for a transfer of assets and assures the business owner of lifetime income. The owner's children make an unsecured agreement to provide a certain amount of income in exchange for equity in the company. This approach removes the company from the owner's estate, while still producing future income. At the owner's death there is no asset in his estate to tax..

For children who are active in the business Stock as Compensation in the form of options

compensation is taxable as income and must meet the IRS standards for "reasonable compensation."

There are two common denominators to all of these strategies. All require an accurate valuation of the business. In addition every shareholder of a privately held business should have a buy-sell agreement in place to govern the disposition of their stock in the event of death, disability, retirement, or withdrawal from the business. The buy-sell agreement can be in the form of stock redemption or cross-purchase, and may be funded by disability or life insurance.

Failure to plan may unnecessarily subject the owner to excessive estate taxes that could ultimately force all or part of the business to be sold, possibly at a distressed price. A business owner also may jeopardize the ability to have a financially secure retirement if a well-conceived succession plan is not in place.