Business Succession Planning

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Contents

Introduction

Many business owners may be more focused on running their company than planning for retirement. However, owners should consider what will happen once they leave the business, whether by selling, retiring, becoming disabled or passing away. A well-conceived succession plan allows the owner to exit the business and will address tax, business, estate and liquidity considerations in light of family dynamics. This brochure highlights some key points to discuss with your client and their professional team, including their Edward Jones financial advisor, but does not cover all facets of succession planning.

Business Succession Professional Team

Each succession plan will have different needs. Thus, not every advisor mentioned will be needed on every plan. The core team of professionals that can assist the business owner, and possibly the owner's spouse and children, may include:

- ***An attorney who is skilled in both business and estate planning.*** If the business is very complex, the owner may need to retain one attorney who specializes in contract negotiations and business transactions, and another with knowledge of tax and estate planning.
- ***An accountant who is familiar with the financial conditions of the business.*** The accountant may have input on how to structure the sale or transfer.
- ***An Edward Jones financial advisor.*** The financial advisor can provide information on the owner's retirement, estate and charitable planning goals. The financial advisor may also have insight into the owner's income needs, which can impact the exit strategy. As noted under the heading "Additional Owner Needs," below, an Edward Jones financial advisor can assist with planning for additional needs, such as obtaining life insurance.
- ***A business valuation expert.*** As noted below, valuation of the business is an important part of the plan.

However, additional advisors may be needed. If trusts are part of the estate plan, the owner can appoint a corporate trustee to manage and preserve trust assets on behalf of the beneficiaries. If the owner chooses to exit the business via a sale, a business broker can help the owner obtain the best sale price for the business. Some owners may need to retain an investment banker (also called a mergers and acquisitions specialist) to prepare marketing materials and financial forecasts for the business. The investment banker may also find potential buyers and negotiate the sale terms. If an employee stock ownership plan (ESOP) is involved, the owner may need to retain an attorney and an accountant familiar with pension law.

Value: A Key Component of Every Exit Option

To help the business owner develop a succession plan, it is important to determine whether the business has value as a going concern. "Going concern" value is the value of an active business with future earning capacity, as opposed to the liquidation value of its assets. If the business has little or no value as a going concern, the succession plan may shift to personal planning and the disposition of assets. If the business has, or is developing, value as a going concern, the owner may need to use an appropriate exit strategy to increase or preserve value.

Marketable value generally does not exist where the business cannot survive without the owner. The owner's legal and tax advisors may have knowledge of the business's value. Often, a valuation expert will need to appraise the business and determine its value as a going concern. The value should take into account various items, including the business's physical assets, managerial experiences and revenue projections, and whether these factors can be sustained by a succession plan. Some of the organizations offering professional designations which evidence experience and expertise in business valuation are listed below and may serve as a useful resource for advisors seeking assistance in valuing a business. Visit the websites, or contact these or other organizations, to learn more about their credentialing process.*

Organization	Designation	Contact Information
American Society of Appraisers	Accredited Senior Appraiser (ASA) Accredited Member (AM)	www.appraisers.org 800-272-8258
American Institute of Certified Public Accountants	Accredited in Business Valuation (ABV®)	www.aicpa.org 212-596-6200
National Association of Certified Valuators and Analysts	Certified Valuation Analyst (CVA) Certified Business Appraiser (CBA) (This certification is no longer available to interested candidates. However, NACVA continues to support existing credentialed CBAs.)	www.nacva.com 800-677-2009

* Edward Jones does not endorse or have a relationship with these entities.

Other questions regarding the valuation of the business may include whether the proceeds from a business sale will be paid in cash, require owner financing, provide the owner with sufficient retirement assets and permit the owner to pass assets to heirs.

Possible Exit Options

After the going concern question is answered, the business owner has multiple options when considering which exit strategy makes sense for the business. Each option has its own unique set of considerations and tradeoffs, but typically aligns with one of these four types:

1. Transferring to Family Members, Employees or Co-owners

In many cases, if the owner chooses to transfer ownership to family members (typically the owner's children), the owner must be willing to also give up decision-making and control. The owner should consider whether the children are willing and able to take control of the business, as well as how the transfer will provide cash flow to the owner to finance retirement. Another consideration is whether the transfer will be equal among the children and, if not, how any imbalance could affect the siblings' relationship. If the transfer to some children or family members results in an inheritance imbalance, the owner can bequeath other assets or purchase life insurance to provide cash to certain family members at his or her death. An estate-planning attorney and accountant can help in trying to ensure that the transfer aligns with the owner's wishes. See the discussion under the heading "Importance of Estate Planning" for more information.

If transferring ownership to the owner's children or other family members is not a viable option, the owner and advisors may consider whether any employees are potential candidates for owning the business. One method to transfer ownership to employees is the use of an employee stock ownership plan (ESOP). An ESOP can provide tax advantages, as well as deferred or restricted compensation to the owner and employees. An ESOP may only be appropriate if the business can support that strategy. Generally, this means that the business should be profitable and able to justify the costs involved in creating the ESOP, including preparing a valuation, creating plan documents, and fees for legal and accounting services, as well as the annual costs of administering the ESOP.

Transfers to family members or employees can be accomplished through sale at fair market value, sale at less than fair market value, a gift, redemption, use of an ESOP or some combination of these methods. The owner and advisors may want to discuss transition issues, including formal and informal training for the next generation of owners, and the introduction of the new management to key suppliers, lenders, customers and professional advisors.

In addition, sales to co-owners may be accomplished using buy-sell agreements, which can be financed with life insurance proceeds. Buy-sell agreements are discussed in detail under the heading "Additional Owner Needs."

2. Selling to Third Parties

An arm's-length sale to an unrelated third party can often provide the owner with the best source of cash to fund the owner's retirement. To find a buyer, the owner may consider using a business broker. A business broker functions in much the same way as a real estate broker for a home sale, typically helping to locate potential buyers and assisting with negotiations. An attorney and CPA should be involved as well.

To maintain the value of the business, the owner will likely need to continue running the business until the sale is final and may be asked to continue business operations for a period of time. Often, nondisclosure agreements are signed during the negotiation process. It may be appropriate to advise employees of the pending sale, and efforts should be made to retain key employees. However, a sale to a third party can limit the amount of control the owner has over how the third party may retain or take care of employees.

3. Going Public

Issuing stock to outside investors may be an option for a family business that is an established, profitable company with good management. However, going public is typically not a viable option for most small businesses. Selling equity in the business can provide the company with capital and provide owners with liquidity. An initial public offering (IPO) will often result in an increased market value of the company's stock, which would increase the owner's net worth. The stock becomes publicly traded, generally allowing the owner to more easily sell the stock for cash. The fair market value may more easily be determined after an IPO.

Going public will require additional professional assistance, including the services of an investment banker, accounting firm and securities attorney, in addition to the core professional team. If the business chooses to go public, additional considerations may include cost, administrative and legal requirements, management changes and dilution of ownership.

Another possible scenario is that the family business is sold to a publicly held company. In that situation, the transaction may be structured as a tax-free reorganization. In a tax-free reorganization, all family business stock may be exchanged for the purchasing corporation's stock. If the transaction qualifies as a tax-free reorganization, no taxes are due at the time of the sale. If property other than stock ("boot") is received, gain is recognized. Because there is investment risk in a tax-free reorganization, the owner needs to be advised by an accountant and attorney on the retention period of the purchasing company stock. In addition, there is some risk in holding a concentrated portion of wealth in one corporation.

4. Winding Down and Liquidating

Winding down the family business usually occurs when there is no other viable option. For example, a sole proprietorship legal practice may be wound down if the cases are handled by one attorney, where the current clients have sought the attorney's specific expertise, and the practice has no goodwill or going concern value. After the business is wound down, saleable assets would be liquidated.

Before winding down a business, an owner who thinks there is no potential salability should still consider consulting a professional, such as an accountant, tax attorney, or business broker, to determine if there is a market for the business. The owner should also consider consulting an accountant to determine the tax consequences of liquidation, which are generally dependent on the structure of the entity. In general, corporate assets received in liquidation are valued at fair market value. Conversely, partnership assets received in liquidation are generally valued at the tax basis of the partner's partnership interest.

Techniques and Tax Issues

Various techniques and their tax implications should be considered when developing the business succession plan. The discussion below highlights some of the more common federal tax consequences depending on the succession plan option chosen by the owner. There are also options that may be available even without formal planning. These are discussed under the heading "Statutory Relief Provisions." Because the Internal Revenue Code and Treasury regulations are often amended, it is necessary to keep up with the current status of the law and its potential impact on any particular transaction.

Sale of Business

Every business sale is unique, so owners and buyers should consult their accountant and attorney team to discuss the considerations for how to structure the deal. The sale may be structured as an asset sale or a stock sale, depending on the type of business entity and whether the business will continue to operate or be liquidated.

The sale of a capital asset, such as stock or goodwill, is subject to capital gains tax. Although capital gains tax rates are generally more favorable than ordinary income tax rates, the resulting tax may still be substantial. With a closely held business, there may be little or no cost basis when computing the taxable gain. Therefore, the after-tax proceeds need to be considered, since much of the sale may be taxable.

The sale of some assets (e.g., inventory, accounts receivable or depreciation recapture) is subject to ordinary income tax. In addition, it is important to be aware of the potentially negative impact of the Net Investment Income Tax (NIIT), discussed further below.

If selling assets, the owner is generally required to allocate the sale price specifically between the tangible and intangible assets. If the allocation is recognized as valid by the IRS, it will likely control the tax treatment of the sold assets for the owner and the buyer.

Installment Sales

The advantages of an installment sale for the owner may include a higher sale price, continued income stream and tax advantages from using the deferred installment method for reporting gain. Tax is deferred on the sale until payments are received. Potential disadvantages include the risk of default, potential future tax rate increases and the opportunity cost of deferring the receipt of principal.

For the sale to qualify as an installment sale, the owner/seller must receive at least one payment after the tax year of the sale. It is permissible for a seller to elect out of the installment method. The owner should work with professional advisors to decide whether an installment sale is more advantageous than other alternatives, such as waiting for a better price and a cash buyer, or substantially reducing the price for a quick cash sale. The answer will depend on several factors, including how much cash the buyer will pay in the year of sale, how much of it will be left after selling expenses, paying off existing mortgages and taxes, and the present value of the principal and interest payments on the note. The shorter the note's term, the greater the present value of total payments will be. Particularly if the seller has any doubts about the buyer's ability to pay over the full term of the agreement, the seller may want to bargain for self-amortizing principal and interest payments on the note and resist receiving interest payments only during the term, with a balloon payment of remaining principal at maturity.

Spreading income from the sale over multiple years may help the owner manage adjusted gross income (AGI) and potentially qualify for certain tax credits or deductions that are based on income. For example, if the owner/seller is enrolled in Medicare, keeping modified adjusted gross income (MAGI) under certain thresholds can help avoid higher premiums for Medicare Part B and Medicare prescription drug coverage. (For further information, see www.irs.gov/newsroom/questions-and-answers-on-the-net-investment-income-tax at the IRS website.) Depending on the situation, this may be an element in determining the amount and duration of the installment payments.

The seller should also consider whether the potential risk is worth the potential reward and whether any such risk can be minimized. The seller can minimize risk by following basic underwriting procedures, such as conducting a credit check of the buyer, reviewing the buyer's audited or certified financial statements, and verifying the buyer's legal status and capacity to enter into the agreement. Beyond these basic precautions, the seller may want to try to make the buyer personally liable for the loan, obtain additional security by requiring the buyer to provide other collateral (such as commercial real estate or liquid investments) or obtain a third party's guarantee (e.g., a standby letter of credit).

Goodwill and Other Intangible Assets

Under the Internal Revenue Code, if the sale of a business is structured as an asset sale rather than a sale of stock, the sale price generally must be allocated among the various assets sold, including the tangible assets of the business, such as machinery and inventory, and intangible assets, which can include customer lists, patents and goodwill. Goodwill includes prestige of the business, ownership of a brand or trade name, or successful operation over a prolonged period of time in a particular locality. Special rules control how the allocation is made, and an accountant or other tax advisor should be engaged to determine the allocation.

Consulting Agreement

As part of the sale transaction, there may be provisions for the owner to provide consulting services to the buyer. Payments for consulting are generally treated as ordinary income to the owner and subject to self-employment tax. A consulting agreement may also provide a business income deduction to the buyer. The owner may also wish to negotiate for continued health insurance benefits during the term of the consulting agreement.

The owner should work with an accountant to determine if any above-the-line deductions (e.g., home office expenses) are allowed. Income may also be offset by contributions to a retirement account. The owner should also consult with an attorney or accountant to discuss the impact consulting income could have on the owner's Social Security benefits. If the owner has not yet reached full retirement age but is receiving Social Security benefits, any earned income (including consulting income) in excess of a threshold amount could reduce the benefits received by one dollar for every two dollars of earnings in excess of the threshold amount.

It may also be possible to negotiate an agreement that includes the continued employment of current management for a period of time. This may be of particular interest to the owner with family members or trusted longtime employees occupying management positions within the company, who would benefit from a gradual transition period toward employment outside the company. The terms of such an agreement should be reviewed carefully by legal counsel to assure that the intentions of both sides are clearly stated and understood.

Employee Stock Ownership Plan as Buyer

An ESOP can be a buyer for the owner's interest. If an ESOP purchases stock from the owner, the company may be able to deduct purchase payments, and the owner may be able to defer tax on the sale.

Such a plan may generally be structured as follows: The ESOP can borrow funds from a bank, the ESOP trustee borrows the money, and the loan is guaranteed by the company or the shareholder. The loan proceeds are then used to purchase company stock from the company or the owner. The company makes tax-deductible contributions to the ESOP to allow the trustee to make payments on the loan. As a result, the employees have the company stock, the owner receives the sale proceeds, and the company repays the loan with tax-deductible funds.

Deferral-of-gain recognition on the sale of employer securities to an ESOP may also be available if certain holding-period and percentage-of-ownership requirements are met. This provision may permit substantial owners of a company with an ESOP to not only sell their stock to the ESOP, but also establish a diversified portfolio of marketable securities without incurring tax. Securities in the portfolio take the basis of the ESOP stock sold and, if held until death, the estate and heirs get a step-up in basis that eliminates income tax liability on all appreciation before the time of death.

If the owner sells the acquired securities, any realized gain will be subject to taxes.

If the owner is interested in pursuing an ESOP strategy, he or she should consult an accountant, attorney and financial advisor who are familiar with the details of establishing and maintaining an ESOP. Due to the complexity of these rules, it may also be advisable to consult with a pension expert.

Transfers to Family Members

Transferring ownership in a business to family members can be accomplished with a variety of techniques, such as outright gifts, transfers to a family limited partnership (FLP) or limited liability company (LLC), private annuity, grantor retained annuity trust (GRAT) and installment sales, including an installment sale to an intentionally defective grantor trust (IDGT).

Challenges to passing the business on to the owner's children include ensuring an adequate cash flow to fund the purchase, maintaining adequate cash flow to continue business operations, and minimizing income and transfer taxes.

The business must be valued fairly. Although many business owners wish to keep the valuation low when transferring to family members, the IRS may not agree to that valuation. Accordingly, the valuation should be performed by an independent valuation expert who is qualified to value the type of business being transferred.

A lifetime transfer of business interests for less than fair market value may be treated as a gift, subject to the federal gift tax. The owner can make use of the gift tax annual exclusion amount to transfer interests in the company to family members. The owner can also make lifetime gifts, up to the lifetime gift tax exemption, that would not be subject to gift taxation. However, any use of the federal unified credit on lifetime gifts reduces the amount that can pass free of estate tax at the business owner's death.

Transfers at death for less than adequate consideration are generally subject to the federal estate tax. Values above the federal lifetime exclusion amount are taxed at the applicable federal estate tax rate and, with respect to transfers at death, may also be subject to state estate or inheritance taxes.

Family Limited Partnership

The FLP strategy requires the creation of an entity (which could also take the form of an LLC or limited liability partnership) and transfer of assets that have the potential for high appreciation. In exchange for the assets, the transferor (typically the parent) usually receives a relatively small general partnership interest (typically 1% or 2%) and a large limited partnership interest. The parent retains the general partnership interest and transfers a portion of the limited partnership interest to the children over time. The general partnership interest gives the parent effective control over business operations, even though this interest represents only a small percentage of the business's value.

The interests received by the children are typically minority interests. Under the normal principles of valuation, the children's limited partnership interests are worth less for transfer tax purposes than the same proportionate interest in the underlying assets. A minority interest is worth less because the holder cannot make control decisions about the business, demand distributions or force a liquidation. These factors also mean that such an interest may be less marketable than an interest in the underlying assets of the business. The business interests also typically lack marketability due to transfer restrictions in the agreements governing the business operations, such as the partnership or operating agreement. Accordingly, minority interest and lack-of-marketability discounts are generally allowed on the transfer of limited partnership interests in an FLP and can sometimes result in significant discounts.

Although parents want to reduce their estates by making gifts to the children, they are often reluctant to give up all control over the transferred assets. They may be concerned that the children are not ready to manage the business wisely. If properly structured, an FLP allows the parents to transfer economic interests in the business to their children while retaining significant control over the underlying property and the income it produces, because the parents, as general partners, will make the management decisions.

Besides valuation discounts and control, other potential advantages of an FLP include:

- ***Ease of amendment.*** At least in comparison to trusts and certain other entities, many state laws make it relatively easy to amend a partnership agreement.
- ***Creditor protection.*** The partnership entity may make it more difficult for creditors to reach the underlying partnership assets.
- ***Annual exclusion gifts.*** It may be easier to make gifts of partnership interests rather than gifts of the underlying assets.
- ***Aggregation of management.*** An FLP may allow a family to aggregate assets that require management into one structure. It may also provide the older generation an opportunity to mentor the younger generation in how to make sound decisions regarding the underlying assets.

FLPs are not completely without faults. Major potential disadvantages of an FLP include:

- ***Cost.*** Legal fees for setting up an FLP, as well as appraisal and valuation fees, could be significant.
- ***IRS review.*** The IRS has generally taken a skeptical approach toward the use of FLPs. However, many of the cases in which the IRS has been successful were those where an existing family business was not involved. When establishing and operating an FLP, it is important to maintain certain structural and record-keeping formalities to mitigate IRS scrutiny. As a general rule, an FLP may not be appropriate merely for tax reduction purposes.
- ***Loss of stepped-up basis.*** Using an FLP to transfer assets results in a tax trade-off. Although transfer taxes may be greatly reduced, the recipients may take a much lower "carryover basis" in the transferred assets rather than the stepped-up basis ordinarily attributed to assets received from a decedent's estate. The transfer tax advantages should be weighed against the possible income tax disadvantages. It is important for the business owner to work with an accountant or CPA concerning the tax implications of this strategy.

Private Annuity

The owner can also consider entering into a private annuity arrangement. Typically, the owner sells the business interest to a family member in exchange for lifetime income. If a private annuity is used, the value of the business is generally not includible in the owner's gross estate at the owner's death, so long as the value of the annuity equals the value of the transferred interest. If an annuitant transfers his or her entire interest in property in exchange for a single-life annuity, the value of which is equal to the value of the transferred property, then the annuity is extinguished upon the death of the annuitant and would not be included in his or her estate for tax purposes. However, if an annuitant allows the capital portion of each annuity payment to accumulate and lives longer than his or her life expectancy, the amount retained may be included in the annuitant's gross estate at death.

At one time, this technique was very favorable because income tax liability was deemed to be incurred as payments were received. However, the IRS has since issued regulations that significantly alter that result for annuities received currently. Under these regulations, if an annuity contract is received in exchange for property other than money, the entire amount of the gain or loss, if any, is generally recognized at the time of the exchange, regardless of the taxpayer's method of accounting.

Grantor Retained Annuity Trusts

The owner can also consider transferring business interests to a GRAT and receiving a stream of income for a fixed term of years. At the end of the term, the principal passes to the beneficiaries. The present value of the remainder interest may be treated as a gift. The value of the remaining annuity payments may be includible in the owner's gross estate if the owner dies before all annuity payments are made. Income generated by the trust is generally includible in the owner's taxable income.

A GRAT can be a means to leverage the value of an individual's lifetime exclusion amount to transfer assets from his or her estate at little or no gift tax cost. It is often referred to as an "estate freeze" technique.

Example

Greg Handy establishes a five-year GRAT with $1 million of assets at a time when the applicable federal tax rate is 3.4%. The assets transferred to the GRAT are expected to grow at an annual rate of 8% and produce a 6% income stream. Using what is known as a "zeroed-out" or "Walton" GRAT, the transfer to the trust results in no gift tax cost. The remainder, which goes to the beneficiaries, amounts to over $479,000, even though Handy has been paid an annuity of almost $221,000 per year over the term of the trust.

Before entering into a GRAT transaction, the health and lifestyle of the creator should be examined. Failure to live through the full term of the trust can negate the tax advantages. For this reason, GRATs are often established for relatively short durations, such as two or three years, and then a new GRAT is created and the process repeated. This technique is often referred to as "rolling GRATs."

It should be noted that GRATs have been the target in recent years of legislative proposals that would greatly reduce their effectiveness as an estate tax saving device. Consequently, it is important for business owners to consult with attorneys and advisors who are experienced in this area and who are well versed in the current law and regulations relating to GRAT operation.

Installment Sale to an Intentionally Defective Grantor Trust

Another estate tax reduction technique is the sale of shares in the business to an IDGT established for the benefit of children who are active participants in the business, in return for a stream of payments to the parent-owner, often in the form of a promissory note. The trust is "intentionally defective" in that the terms of the trust are written so that the business owner, who is the creator of the trust, is considered to be the owner of the trust for income tax purposes. Accordingly, the owner may be responsible for paying income tax on the income of the trust and, if the trust is properly drafted, the payment of tax will not constitute a taxable gift to the children.

The trust is not defective for estate tax purposes. In other words, the owner may not be considered the owner of the business for estate tax purposes. This results in what might be described as the best of both worlds. The irrevocable nature of the trust means the business owner does not have sufficient control to cause inclusion of the trust assets for estate tax purposes. However, the degree of control may be enough to trigger income tax for the owner/grantor, and because the transfer to the IDGT is a sale, there is no taxable gift. In addition, under the grantor trust rules, sales between the grantor and the IDGT are generally not recognized for income tax purposes.

The technique of sale to an IDGT is similar to a GRAT, but without the mortality risk. However, one disadvantage of the IDGT is that, unlike a GRAT, it is not a statutorily approved technique. Due to the complexity and care needed in drafting an IDGT, owners should consult an experienced attorney or other tax advisor when contemplating this strategy.

Self-canceling Installment Note

In the case of an installment sale of a business to a child or to a trust for a child's benefit, the promissory note used may be in the form of a self-canceling installment note (SCIN). As with a private annuity, all remaining payments due on the note are canceled at the death of the owner/seller, and a SCIN does not result in estate or gift taxes. For this technique to work, the buyer must pay a premium in return for the cancellation feature. This may result in a higher interest rate or a higher purchase price. One advantage over a private annuity is that gain under a SCIN is generally recognized by the seller only as payments are received. When the seller dies, any unrecognized gain under the SCIN as of the seller's death may be reportable on either the seller's final income tax return or on the fiduciary income tax return of the seller's estate.

Statutory Relief Provisions

Up to this point, the discussion has focused on business techniques that are actively planned. However, there are also relief provisions in the Internal Revenue Code and Treasury regulations to assist in the continuation of a closely held business after the death of an owner, regardless of prior planning. The two major relief provisions are distributions in redemption of stock to pay death taxes and installment payment of estate taxes. Because the Internal Revenue Code is often amended, it is necessary to keep up with the current status of the law and its potential impact on any particular situation.

Stock Redemption

Although the redemption of stock in a closely held corporation is ordinarily taxed as a dividend, there is an exception for sales by an estate or heir, up to the amount of the estate tax and certain other administration expenses due. The stock may receive a stepped-up basis to its value on the date of the share owner's death, and the taxation of gain, if any, would generally be at long-term capital gains rates. To qualify for the exception, the stock to be redeemed must be included in the deceased shareholder's estate, and the value of the stock must exceed a certain percentage of the deceased shareholder's adjusted gross estate. This exception allows the tax-free use of a closely held corporation's cash to pay a deceased shareholder's estate tax and other administration expenses.

Estate Tax Deferral

Although federal estate tax is due and payable within nine months of death, the Internal Revenue Code generally allows the estates of closely held business owners to spread out the estate tax payments. To qualify, the value of the closely held business must exceed a certain percentage of the business owner's adjusted gross estate. If this threshold is met, the estate taxes attributable to the business interest may be deferred for a number of years, during which time only interest on the tax is due. After the deferral, the business owner's estate is generally allowed an additional number of years to make annual payments of principal and interest. However, several qualifications and restrictions must be met to qualify for deferral of estate taxes. Accordingly, estate tax deferral may be considered less of a planning technique and more of a last-chance opportunity to save the business.

Estate tax deferral can be combined with a "Graegin loan," which is a loan from a related party (such as a family member or an entity controlled by the family) to the business owner's estate. The interest on the loan paid by the owner's estate remains in the family and the business owner's estate may be allowed to deduct the interest on the estate tax return.

Additional Owner Needs

As part of the strategic planning for business succession, owners should also anticipate the unexpected, such as what would happen to the business in the event of their death or disability. Buy-sell agreements and life insurance are two tools that could be considered when preparing for unexpected events.

Buy-Sell Agreements

A buy-sell agreement governs the transfer of a business owner's interest. The agreement can be triggered by the owner's death and may also protect the owner in situations such as divorce, bankruptcy, disability or retirement. A buy-sell agreement can often be found in the corporation or partnership operating agreements for a business, or may be a separate legal document.

The owner should consult with an experienced attorney in preparing the agreement and have an attorney and an accountant review the agreement every few years, or upon significant personal or business events. For example, updates may be needed to reflect changes in business value, legal organization of the business, ownership (e.g., owners who have died, retired or withdrawn), and stockholder or partner ownership percentages.

There are three types of buy-sell agreements:

1. ***Cross-purchase agreement.*** This is a buy-sell agreement solely among shareholders.

Example

A corporation has two shareholders, Cindy and Sally. Cindy and Sally each agree that upon the death of one, her estate must sell her stock in the business, and the survivor must purchase it.

2. ***Stock redemption agreement.*** This is an agreement between the corporation and its shareholders where the corporation agrees to buy (redeem) the decedent's stock.

Example

A corporation has two shareholders, Al and Tony. The corporation agrees to buy the shares of the first shareholder to die. Al and Tony each agree that the survivor's estate will sell to the corporation (or tender for redemption) the shares he owns.

3. ***Hybrid or combination agreement.*** In this type of agreement, the corporation and the stockholders agree to buy the deceased shareholder's stock. Such an agreement consists of both a cross-purchase and a redemption agreement.

Example

A corporation has two shareholders, Sam and Susan, who each own 100 shares of stock. There is a cross-purchase agreement for 50 shares of stock and a stock redemption agreement for the remaining 50 shares. From a tax standpoint, it may be preferable for the purchase to occur before the redemption. If the surviving stockholder does not buy the agreed-upon portion (50 shares) prior to the other shares being redeemed by the corporation, the redemption proceeds may be taxable as a dividend to the deceased shareholder's estate.

The buy-sell agreement can be funded with life insurance. Properly structured agreements can set the fair market value.

Uses of Life Insurance

In a multi-owner business or a multi-generation family business, the unexpected death of an experienced and successful owner can have a dramatic and negative financial impact on the surviving owners, especially a surviving spouse. An owner's death may potentially result in the loss of customer accounts, a decrease in revenue, management disputes, diminished employee loyalty and an inability to secure commercial loans for credit lines or expansion.

For succession planning, life insurance can be one of the most cost-efficient risk transfer strategies to protect a business owner in preparing for the unexpected. In the event of the owner's death, the capital provided by life insurance can help a business in a variety of ways.

Life insurance in conjunction with a buy-sell or key employee agreement. Life insurance proceeds paid to a business in the event of an owner's death can allow the business to do the following:

- Redeem the owner's interest in the business to buy out a surviving spouse or children who have no interest in becoming owners
- Pay operating expenses, such as rent and utilities
- Liquidate a commercial mortgage
- Meet payroll
- Maintain credit lines with commercial banks
- Hire additional management personnel to keep the business running until family members can have a transition period to learn the business
- Purchase land, buildings and equipment needed for expansion

Without the funding vehicle of life insurance, the remaining owners may financially struggle to purchase the interest of a deceased owner through existing business cash, a commercial loan, venture capital or an unsecured installment note.

Life insurance to facilitate a succession plan. Life insurance can also be used by business owners who are selling their businesses on an installment basis (see discussion of installment sales under the heading "Techniques and Tax Issues"). In this strategy, the owner insures the life of the buyer. If the buyer dies unexpectedly, the owner receives the life insurance proceeds to pay off the promissory note.

The buyer may also purchase a policy on the business owner's life. If the business owner dies unexpectedly, the buyer can use the insurance proceeds to purchase the business owner's interest from the surviving spouse or estate.

Business owners should consider life insurance as part of the negotiated terms for the sale of their businesses. Level-premium term-life insurance for a stated period of time (10, 15 or 20 years) can be a cost-efficient risk transfer strategy to ensure the completion of a business succession plan.

Life insurance to satisfy the business owner's personal financial needs. In the case of a family-owned business where there are no heirs or non-family employees capable of taking over, a succession plan to sell or liquidate the business at a steep discount, or simply to close the doors, may be the owner's only option.

In this situation, it's still important for owners to financially protect themselves, as well as their spouse. For the business owner, personal life insurance can provide for a surviving spouse's income needs, pay bills and educate children. Disability insurance can replace a percentage of the owner's income if he or she suffers a permanent injury or illness, rendering him or her incapable of operating the business. For business owners in their late 50s or early 60s, long-term care insurance can be a valid way to secure a monthly cash benefit for a set period of years to pay for potential future medical expenses arising from the need for nursing home care.

Using an Irrevocable Life Insurance Trust

To avoid the possibility of life insurance proceeds on the life of the owner being includible in the owner's estate for estate tax purposes, it is necessary for the life insurance to be owned by someone other than the owner or by an entity. Generally, the most common entity for such

ownership is an irrevocable life insurance trust (ILIT). The ILIT will be the owner of the policy for the benefit of others, such as the owner's spouse and children. To facilitate the payment of premiums using annual gift tax exclusions, the trust instrument should provide the beneficiaries with certain limited withdrawal rights (known as "Crummey" powers, after a court case of that name).

Importance of Estate Planning

Business owners, regardless of their net worth, should work with their professional team to integrate estate planning with any succession plan. Even the best business succession plan may fail if basic estate planning is overlooked or not refined over time to reflect changing family situations tied to owner succession, management transition and transfer tax issues that may occur over the course of an owner's involvement in the business.

Family changes that can impact the estate-planning process include marriage, the arrival of children and grandchildren, divorce, second marriages (with blended families), and marriages and divorces of adult children. Most business owners understand the need to revise their estate plans with their attorney to accommodate changing circumstances and goals for the transfer of business and non-business assets during the owner's lifetime or at death.

Some clients may be concerned with avoiding probate, which can be inefficient and expensive, depending on state and local law. Owning assets in a revocable or irrevocable trust can help avoid probate at the client's death. Trusts can also provide an added layer of asset protection for surviving spouses and for adult children and grandchildren.

It is also important to remember that not all assets pass by way of a will or trust document. Many assets are beneficiary designated (e.g., qualified retirement plans, IRAs, annuities, life insurance, bank accounts, investment accounts and real estate). These beneficiary designations should be reviewed periodically to ensure they are aligned with other aspects of the estate plan and reflect changes that have occurred since they were initially made, such as divorce or the death of a spouse.

Another important concern is the issue of "fairness." Equal division of business interests among family members may not be a fair division if one child has contributed significantly more than the other children to the business. A more appropriate division may involve transferring business interests to the children who will be involved in the business and different assets to the other children. Equal values may or may not be appropriate. The owner's goals, the best interests of the business, and the relative contributions of the children may all be considered in determining what ultimately is fair.

If the business is disproportionally transferred to one child, the professional team can help the client explore ways to equalize the inheritance among the other children. Life insurance is often used to help in this situation. The owner can be counseled on discussing the estate and succession plans with children.

Finally, important estate-planning documents should be kept in a safe deposit box or other location known to the executor. In today's digital age, it is also important that the attorney-in-fact or executor understand the laws and rules applicable to digital assets and have the necessary authorization, user identification and passwords to gain lawful access to an incapacitated or deceased client's electronic accounts. Many states have passed laws governing access to a decedent's digital assets. The transfer of ownership rights to the decedent's digital assets should also be specifically mentioned in the decedent's will, trust or other estate-planning documents.

Post-exit Financial Strategy

Successful business owners are often accustomed to having a majority of their assets tied up in their businesses. After a sale is complete, the owner's investment goals may change.

Income should be planned for and holdings should be diversified to achieve the desired balance of growth, income and principal preservation. If an owner sells the business to a publicly held company and receives publicly traded stock as part of the sales consideration, a strategy should be put in place to diversify those holdings in a manner that conforms to any securities law or agreement-based restrictions that may exist.

A recipient of restricted stock may elect to include in income the excess of the fair market value of the stock over the amount paid for it. This election can have the effect of accelerating recognition of income to the date the option was exercised as opposed to the date the restriction lapses. This could be beneficial in that future appreciation in the stock value would be treated as capital gain. However, this election has its downside as well. For example, if the value of the stock goes down after the election is made or the stock is later forfeited because of failure to meet one of the goals related to the restriction (e.g., failing to complete the required period of service), the individual may have paid tax on income from which he or she never benefitted. Also, revocation of this election is only possible under rare circumstances, which do not include a decline in the value of the stock. Consequently, such an election should be approached with great caution.

Conclusion

As baby boomers age, professional advisors may be called upon to address planning for business exits and succession planning. Approaching these strategies as a process and working with a team of legal, tax, accounting, insurance or financial professionals can help professional advisors address the situations their clients may face.

How Edward Jones Can Help

Edward Jones is committed to a team approach for meeting client needs. Edward Jones financial advisors collaborate with our clients' CPAs, attorneys and other advisors to work toward a common objective: helping those clients preserve, manage and distribute their wealth while meeting their financial goals. Working in concert with tax and legal professionals, an Edward Jones financial advisor can help business owners develop strategies that assist them in meeting their financial goals, both personal and professional. To learn more about how this team approach can help you serve your clients' best interests, contact an Edward Jones financial advisor today.

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