

# Estate and business succession planning

Challenges that business owners contend with when transitioning the business to the next generation. **by Gerald M. Morello, Jr.**

**T**his month's issue of the Profile focuses on the challenges that business owners contend with when transitioning the business to the next generation. I have had the pleasure of writing in previous issues of the Profile on the related topics of "How To Plan Your Estate" (Oct/Nov '06) and "Estate Planning for the Business Owner" (Holiday '06).

*\*These previous articles are available from the publisher or author upon request.*



## BIZ PROFILE

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**B**usiness succession planning, as it is typically described, contemplates current ownership and leadership roles of the business entity, as well as how to transfer the ownership to the next generation and how to fill leadership positions as part of that process. Proper business succession planning involves a team of professionals to handle the intertwined legal, financial, tax and family dynamics that are always part of the process. A strong team of professionals that are experienced in these matters is critical to a plan that will be properly developed and will ultimately succeed when the plan is implemented.

Estate and business succession planning involves multiple steps, and each step builds upon the previous one. The building blocks of a proper plan include the following:

- 1 A comprehensive estate plan**
- 2 Irrevocable Trust**
- 3 A funded Buy-Sell Agreement**
- 4 Family limited liability company**
- 5 A business audit**
- 6 Gifts of family business interests**
- 7 Family Meetings**

*Let's briefly review each of these steps as part of the overall planning process.*

## THE ESTATE PLAN

**T**he first step for business owners is to develop a comprehensive estate plan. A comprehensive estate plan includes a Last Will and Testament, Revocable Living Trust, Durable Power of Attorney (for financial affairs) and Patient Advocate Designation (for medical affairs). The estate plan will also consider current tax laws.

## REVOCABLE LIVING TRUST

**E**ach person, or married couple, and especially a business owner, should utilize a Revocable Living Trust as part of his or her planning. A Revocable Living Trust enables the business owner to transfer assets such as corporate stock, mutual funds, real estate and life insurance proceeds to heirs without probate court supervision. A Trust provides flexibility related to the age your heirs receive their inheritance. A properly designed Trust also provides asset protection for your children from "in-laws, outlaws, predators and creditors."

A Revocable Living Trust should stipulate how the business should be distributed, and to whom, at the death of the business owner. Oftentimes, the business interests are "set aside" to the child who intends to remain in the business and is the heir apparent to the daily operations of the business. However, a question remains as to whether the other children are to be "equalized" with the child who receives the business, or whether the remaining children merely share in the remaining assets (after the business is distributed to the heir apparent), which would result in a lower inheritance value for the remaining children. Oftentimes, the children who did not inherit the business are "equalized" with other assets based on an appraised value for the busi-

ness at the time of death of the business owners. An important consideration for the business owner is what approach to take with the distribution of estate assets, and if there is going to be an equalization to the other children, how that bequest is going to be satisfied.

It is critical that your Revocable Living Trust is "funded" in the most efficient manner. This means that your assets are properly owned by your Revocable Living Trust or name the appropriate beneficiaries, including the Revocable Living Trust. It is a very common error for clients that their Revocable Living Trust is "unfunded." This simply means that the assets are not owned by the Trust. Ultimately, if the Trust is unfunded, all of the assets would be probated and would become part of the public record at the Probate Court. It is important that you continuously review the funding of your Revocable Living Trust with an estate planning attorney and financial advisor.

## IRREVOCABLE TRUSTS

**A**n Irrevocable Trust is established to receive gifted assets from the givers of the gift (the "Grantor") to hold for the beneficiaries. The typical approach is what is referred to as an Irrevocable Life Insurance Trust ("ILIT"). In this arrangement, an insurance policy is owned by the ILIT and the business owner makes a premium payment to pay for the insurance policy. The payment of the premium constitutes a gift to the beneficiaries because the client does not own the insurance policy. The result is superb; the insurance proceeds, at the death of the client, are transferred to the ILIT beneficiaries completely tax-free. In particular, the insurance proceeds pass to the heirs, pursuant to the ILIT, estate, Capital Gains and income tax free. In addition, the

insurance proceeds provide liquidity to pay any potential estate taxes due and owing within nine (9) months of the business owner's death. In addition, the insurance proceeds can act as the equalizer referenced above to the children who are not inheriting the family business.

It is important that the business owner works with an insurance professional experienced with business planning. There are numerous insurance policy designs available; it's important to get it right the first time.

### BUY-SELL AGREEMENTS

**E**state planning for the privately held business is critically important to ensure that the disability or death of a shareholder will not unduly disrupt the operations of the business. Far too often, business owners do not properly plan for such a catastrophic event. The result is that, more often than not, the business will not survive such an event.

There are various planning options that are available for the business owner, including a properly prepared and well thought out Buy-Sell Agreement. This comprehensive document, if prepared properly, will provide how the business will be transferred and/or maintained in the event of various "trigger events", including disability, death, as well as divorce or other unanticipated events of a shareholder. It is also important that the appropriate valuation provisions are included in the document and that the Buy-Sell Agreement is properly "funded" with life insurance as well as disability insurance.

### BUSINESS AUDIT

**I**t is a good business practice for the business owner to have a

"business audit" performed by an estate and business planning attorney to verify that the business is properly structured, the shares of the corporation are properly funded to the Revocable Living Trust, the Trust has the appropriate tax provisions to own the corporate stock, and the Buy Sell Agreement is current and reflects the current distribution and succession goals of the business owner.

A business audit should also include a review of other corporate documents, including the Employee Handbook, Employment Agreements, Non-Compete Agreements, as well as all contracts used in the day-to-day operations. Properly designed legal documents will reduce the likelihood (and expense) of disputes later.

### FAMILY LLC

**O**ftentimes, business owners operate their business enterprise in a commercial building owned and operated by the business owner. An excellent technique is to place the ownership of the real estate in a separate entity, typically a limited liability company (an "LLC"). A family LLC ("FLLC") provides excellent asset protection techniques because this separates the exposure to lawsuits due to acts on the property from the operating business itself. In other words, if an event occurred on the commercial property that triggered lawsuit exposure, the lawsuit would likely be filed by the building owner (the FLLC) and the result is that the business owner's ongoing business as well as the business owner's personal assets would be protected from exposure.

### GIFTS OF INTEREST

**G**ifts of interest in family owned businesses are a very

common transfer technique for the business owner. The gift of ownership in the business enterprise or the FLLC is a very simple and straight forward transaction. The lifetime transfer of shares of stock in the business enterprise or the FLLC allows the business owner to keep the business interest in the family and involves less documentation than a traditional sale of business interest. Also, the business owner can create two shares of stock, voting and non-voting shares, and will typically elect to gift non-voting shares of stock in order to retain control over the day-to-day operations of the business. As a result, the business owner might only retain a small portion of the membership interest of the FLLC while retaining 100% of the voting interest of the FLLC. Given the fact that the business owner would no longer own 100% of the FLLC due to the transfer or gifting of non-voting membership interest to the children, the remaining membership interest of the FLLC would receive a discount in value. In valuing family business interests in general, and the ownership interest for the business owner in the FLLC in particular, substantial discounts are normally allowed for lack of control (minority discount) and lack of marketability. Courts have upheld discounts ranging from 10% to 60% of the normal value of the business. This is an excellent result but must be planned for in a proper and meticulous way.

Gifts of interest in a family business enterprise also needs to be carefully coordinated with death transfer planning. Gifts of family business enterprise interest or FLLC interest can be arranged to take advantage of the \$12,000.00 a year annual exclusion from Gift Tax. The use of the annual gift exclusion can save a substantial

amount of tax at the time of the business owner's death. A husband and wife team may elect to split gifts to take advantage of the \$24,000.00 amount that a husband and wife team is entitled to use together.

## FAMILY MEETINGS

**T**he estate plan (Revocable Trust) and Buy-Sell Agreement generally cover what happens in the case of death, disability or an unexpected tragic event of the current owner. Separately, the succession plan covers changes in ownership as well as changes in the management of the corporation prior to the death of the current owner. It is important that management succession planning also includes the various steps to insure that the proper family

members are slotted in critical leadership roles. Ongoing family meetings will help to develop a plan to bring the children (and grandchildren) into positions of authority with the least amount of argument (and surprise).

When family meetings are initiated, children begin to learn about the family business. During the selection phase, the leaders for the next generation are chosen. Family meetings also include educating and developing the skills needed by the successors. Finally, the transition of authority and accountability to the successors is implemented, most commonly by way of gifting programs (discussed above). Of course, documenting officers and directors in the corporate By-Laws and management agreements is critical from a legal standpoint. Family meetings are critical to set the foundation for

transitioning the business to the next generation in a predictable, planned manner.

*In summary, business owners face certain unique planning challenges that are critical to the survival of the business itself. An experienced estate and business planning attorney may provide an invaluable service in proactively advocating proper planning for the family business owner. The estate and business planning attorney will have the technical tools to assist with this complicated transaction, and should also have the appropriate family counseling skills to help the business owner and his family complete the important planning tasks at hand. Finally, it is important to make certain that the estate and business planning is reviewed from time to time and is maintained with an eye toward current tax law. ■*