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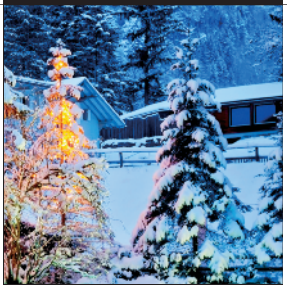

Estate and Tax Planning for Independent Business Owners

Guiding business owners through succession planning involves tax planning and client management skills.

SAM BROWNELL

Independent business owners who run companies with revenues of under $60 million are often overlooked by mid-market investment banks and private equity firms. However, these owners have a significant illiquid asset (oftentimes their largest asset by far) whose value has likely increased over the years and at some point, they will need to monetize the investment to reach their post-ownership goals, which should include financial protection for their family. Because most business owners will only transition ownership of their business once, it is critical that they have a plan to maximize the value of their business while protecting themselves and their families should they die or become disabled. Further, many of these owners are discovering that their children are not interested in running the business, so knowing what options are available for them to create liquidity in a tax efficient manner can mean the difference between a family building multi-generational wealth or having the government dictate their post-ownership plans.

To help both independent business owners and their advisors, this article will use examples from the author's succession planning work that will help answer the following questions:

- If my children don't want the business, what are my options?
- What is the impact of taxes on the sale of a business?
- If I die or become disabled before the ownership transition is complete, how do I make sure my family gets paid for the value I've built?
- Why are buy-sell/stockholder agreements (or permitted transfer language in an operating agreement) so important for wealth preservation in partnerships?
- What are the key items that should be included in a buy-sell or operating agreement?
- What estate documents do I need to have in place as a business owner and how often should these be updated?

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- Should my business be titled to me individually or to my trust?
- How can I pass along my values to future generations regardless of whether they are involved in the business?

Before moving into further discussion of these questions, note that any advisor who wants to help a business owner with succession planning needs to be aware of how important it is to manage the emotions of the business owner. For example, every year the author meets with numerous independent business owners to discuss succession planning. During these conversations, advisors typically ask lots of open-ended questions to learn as much as possible about the owner's goals, expectations, and concerns. As part of this discovery process, the author typically likes to ask the owner what they would most enjoy about transitioning leadership and ownership to the next generation. The answer received from many owners is that they would like to continue to work in the business but would enjoy reducing their long hours and eliminating some of the stress that comes from worrying about employees, customers, and suppliers.

In these conversations, it is rare to encounter an owner who is not an honest, caring, and hardworking person who wants to do the right thing for all the stakeholders involved. At the same time, this intensely passionate devotion to work can lead to a lack of creative thinking when it comes to their planning goals. The business that the owner runs defines who they are to their family and their community but perhaps most importantly, the business often defines how the owner thinks about themselves. Envisioning life without the business to define them can be difficult and becomes even more emotionally fraught when beginning to discuss ownership transitions, what life would look like post-transition, and how they can protect their family and their business.

In the examples below, remember that behind each valuation, succession plan, retirement cash flow analysis, tax plan, and estate plan is a human being that may not be ready to let go of their ownership. It is advisors' job to help the business owner understand that the journey is an important part of finding meaning in their life beyond the business.

What Are the Ownership Transition Options and How Do They Impact Tax and Estate Planning?

It is common for business owners and their advisors to think about intrafamily transfers, transfers to a key employee, and sales to strategic competitors. However, it is important to also consider sales to financial buyers, especially if the industry where the client operates is growing rapidly, and sales to the employees, whether through an Employee Stock Ownership Plan (ESOP) or through a Worker Owned Cooperative (Coop). From a planning and tax standpoint, there can be great benefits to the employee ownership exit strategy and from an operational standpoint, the business is being bought by the employees who typically understand its culture, operations, and strategy better than any outside buyer and in many cases, better than a family member who may not have decades of experience in the business.

For example, when working with the owner of a building materials firm a few years ago, here were a few of the concerns he raised about the prospect of an ownership transition:

1. My children are grown up and have not worked in the business in years. They are happy in their current careers and do not live in the area so a sale to one of them is not a possibility.
2. There is not one person or a group of people on my management team that could run the business. No one can effectively replicate what I do for the business.
3. We are in a semirural area and therefore I do not think we are attractive to larger competitors. If a competitor did want us, I worry that their offer would be lower based on our location.

While all these concerns can and should be addressed during the planning process, for the purpose of ownership transfer options, the important point is that the business owner was limiting their ability to build a succession plan by only considering the "traditional" options. Many business owners get stuck in a negative feedback loop because if their children or employees do not want to buy the business (or the owner feels that these stakeholders are unable to own and run the business) then the owner feels the only choice is to sell to a competitor. This realization creates another negative feedback loop because the owner worries that the buyer might not be a good cultural fit, will fire his or her loyal employees and bring in "their people", and/or reduce or change the focus of the operations, potentially leaving current customers searching for a new supplier. In many instances, the business owner begins to wonder if it would be best to sell their inventory, fixed assets, and the property (if they own it), and close the doors.

In the case of the business owner whose concerns are outlined above, the first question was what he wanted his legacy to be in his family and in his community? As many in the estate planning community have found, it is important to move the client beyond the present and have them think more broadly about what their goals are and how these goals will protect their family. Closing the doors of the business and liquidating inventory is a drastic move that impacts the ability of the parents to create intergenerational wealth, typically creates hard feelings among the employees, who are now out of a job, and damages the local community, which loses one of its larger employers as well as the dollars that were invested in other local business and charitable causes. Business owners are people who often care more about the wellbeing of their families, employees, customers, and community than they do about their own wellbeing. Having them focus on their long-term legacy can help them see the downsides of a liquidation and open their eyes to other possible transfer options.

Another major issue with liquidating inventory, fixed, assets, and property, or a sale to a third party is taxes. Building materials businesses typically have high levels of inventory (and corresponding accounts receivable) that will be taxed at ordinary income rates in a liquidation or a sale to a third party[1]. Further, they also need fixed assets, which typically have been depreciated or expensed and therefore may be subject to recapture at ordinary income tax rates. Finally, if the property is owned by the business, it too has been depreciated and a portion may also be recaptured at a 25% tax rate. For the business owner in question, and for many of your clients, the idea of *net cash flow* from a sale or liquidation is an incredibly important concept that needs to be repeated often. Business owners, who are typically quite careful about taxes in their daily operations, can forget the impact of taxes when they are looking at a sale or liquidation price for millions or tens of millions of dollars. By providing an estimate of what an owner would pay in taxes for a liquidation, advisors can not only save them money, but help them to broaden their thinking about their own succession plan.

Protecting an Owner's Financial Stake in the Business

Regardless of the transition option that a business owner chooses, it takes time to monetize the value of a privately held business and that means there is risk to the business owner and their family if something happens during the transition period. For example, the author worked with two partners who owned a manufacturing company. One of the partners was ten years older than the other partner and they had engaged the author's firm to help them create and implement a succession plan for the older partner. Tragically, during the transition process, the older partner had a heart attack and died. From an estate and continuity planning standpoint, this raised some important questions:

1. What happens to the interest of a deceased owner?
2. How is this interest valued?
3. How will the family be compensated for the deceased owner's share of the business?
4. Who will take over the responsibilities of the deceased owner?

All these questions can be handled by putting in place the right legal documents when everyone is healthy and of sound mind. As most practitioners are aware, business owners typically look at legal documents when the business is formed and when there is a material event (e.g., bringing in a new partner, selling the business, etc.). To encourage regular review of legal documents, the author likes to set up a schedule with clients so that legal documents are reviewed during the initial succession planning process and then every two to three years or when a material event occurs. This schedule helps the business owner keep their legal documents up to date with their goals.

In the case of the partnership where the elder partner died, having a well thought out buy-sell agreement helped the family of the deceased owner create liquidity and protect their net worth. During the initial succession planning process, the following details were specified in their buy-sell agreement since the company was an S Corporation[2]:

1. Define the trigger events that would initiate a buyout of an owner. Specifically, these trigger events are death, disability, divorce, termination, retirement, and personal bankruptcy.
2. More specifically define disability as the inability of an owner to perform their job responsibilities for a period of 6 months. Too often disability is not well defined in buy-sell agreements, and this can lead to arguments and the unnecessary expenditure of time and money.
3. Define how the business will be appraised. In many buy-sell agreements, the business value will be determined by the owners at the time of a sale. This puts a lot of responsibili-

[1] Most sales to third parties are asset sales, where the buyer is not assuming the debt or the seller's entity. In an asset sale, the purchase price is allocated to the assets from the most liquid, cash, to the least liquid (e.g., intangibles). Therefore, the allocation to accounts receivable, inventory, and fixed assets is taxed at ordinary income rates while intangibles such as goodwill are taxed at lower capital gains rates.

[2] These same provisions should be included in the transfers section of an LLC's Operating Agreement. In some instances, attorneys like to include a separate buy-sell section in an Operating Agreement. Regardless of where these provisions are listed, including them is vital to a well-planned ownership transition.

ty on the owners to not only produce a valuation that can stand up to IRS scrutiny, but also to agree on a value in the first place. Because each owner has their own motivation for a certain valuation (e.g., selling owner wants a higher value and buying owner wants a lower value), the buy-sell agreement should state that a qualified appraiser knowledgeable in the subject company's industry should be engaged to produce an objective valuation of the company.

4. Define the valuation date. This may sound trivial, but the date of valuation can have a material impact on the buyout. Therefore, the author suggests the buy-sell agreement state that the valuation date is the month-end immediately preceding the trigger event. In the example, if his partner's death was on November 12, the valuation date would be set on October 31.
5. State that the value from the appraisal will be equity value, not enterprise value. Owners are compensated based on their equity stake in a business, so the buy-sell agreement needs to define the appropriate value to be derived by the appraiser.
6. State whether discounts for lack of control and lack of marketability are allowed. These discounts are applied under various valuation scenarios and reduce the conclusion of value so it is important to decide if these discounts will be used before a trigger event occurs.
7. State how the proceeds of life insurance will be used. In many partnerships, it is common for the company to take out a life insurance policy on each partner and/or for various partners to own life insurance on each other. Therefore, the buy-sell agreement or buy-sell provisions in an Operating Agreement need to state that the proceeds from life insurance can either be used as a down payment (with the rest of the buyout value placed on a promissory note) or those proceeds can be used as collateral to obtain a loan from a bank.

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8. State whether the valuator can adjust the accounting method used prior to the trigger date. In many instances, small businesses may not have strict and consistently applied accounting metrics. For example, they may run the business on a cash basis because it is easier to track but perhaps, they have a large amount of billed but uncollected revenue. In this case, a change to the accrual method may be appropriate to properly reflect the assets and cash flow of the business. Allowing the flexibility for a valuator to decide which accounting method best reflects the assets and cash flow of the business can lead to more accurate results that are less likely to receive scrutiny from the IRS or a disgruntled partner's family.

In the example above, the untimely death of the owner did not cause additional issues regarding the liquidation of his ownership interest because the company had a life insurance policy on the deceased owner's life and the buy-sell agreement stated that these proceeds could be used as a down payment for the deceased owner's share of the business. Therefore, the deceased owner's family was able to receive immediate liquidity to pay for estate taxes and administration. Further, the family also received a stream of income because the remainder of the buyout was put on a five-year promissory note. If the partner buy-sell agreement had not specifically laid out how trigger events (in this case death) were to be handled, it could have caused unnecessary friction between the surviving partner and the family of the deceased partner.

Typical Estate Planning Documents Needed

In 2015, a family business client was looking to transition ownership to their son while mitigating the impact to the business of a change in ownership and managing the cash flow so that the son could pay off part of the business with future earnings. In any engagement, one of the first items to review are the legal documents. These not only provide an idea of potential risks to the business that need to be accounted for in our initial valuation, but they also give an idea of how well the business is protected should anything happen to an owner or key employee.

The client had begun the process of transferring a minority ownership interest to their son via an annual gift but in a review of their ownership documents, it was clear there were risks that had gone unaccounted for now that they had a partner in the business. First, there was no buy-sell agreement in place for the new partnership arrangement. Second, while the father was the majority owner of the business, there was no clear plan for how ownership would pass to his spouse in the case of his death or disability. Third, the son had no estate planning documents and the parents' documents had not been updated in over a decade.

Practitioners can all spot various problems with this scenario. From a valuation standpoint, a business that does not have in place proper risk management for the owners is riskier (and therefore less valuable) and is also not as marketable to outside buyers because their due diligence will likely highlight the risk to a deal if an owner unexpectedly dies during negotiations. From an estate planning standpoint, each time there is a material event (in this case a partial ownership transfer), the estate documents of all parties with ownership interests need to be reviewed and updated if necessary. This may sound obvious, but in many situations ownership transfer takes place over a period of years and the business' legal documents are updated but the personal estate documents are overlooked. Therefore, it is important that all partners review and make necessary updates to the following documents every 2-3 years or when a material event (e.g., marriage) occurs:

1. Personal Wills: The exact documents to protect assets vary by state but each owner, regardless of their ownership interest, needs to have a personal will in place. In intergenerational transfers, the children often do not have wills in place and the parents may not have updated their wills in decades. Since wills in most states define the disposition of tangible personal property and select an executor, all owners should think through these issues and clearly communicate their decisions to their family to reduce the potential for argument if an owner dies.

2. Trusts: For most business owners, it is critical to have a revocable trust that describes their wishes for management and disposition of their assets. Further, if an owner has a trust, many times they have not gone through the process of assigning their business and property to their trust. As readers of this article are aware, not assigning assets to the trust can leave large assets unprotected and may create an increased tax burden to family members. With business owners, the risk of having to pay taxes they are unprepared for from an asset base that is primarily illiquid can be a real hardship for the surviving family members.

3. General Power of Attorney (POA): Since the personal and professional lives of business owners are intertwined, it is important that they have someone designated to take care of their financial affairs should they become incapacitated. Death is certainly an important factor to plan for, but in the author's experience, disability (and divorce) are much more common trigger events. A well thought out buy-sell agreement can handle disability from a business perspective but without a POA, there can be unnecessary intrafamily disputes about how to handle the owner's finances and whether the POA should be compensated.

4. Medical Directives (Health Care Power of Attorney): Depending on the state, owners should have a separate medical directive that dictates how they want to be cared for if, for example, they are in a coma following a car crash or have a stroke. Like the POA, medical directives for the business owner can avoid intrafamily squabbles if one party wants to keep the owner alive and another party thinks it is time to say goodbye.

5. Professional Will: Sometimes called a "Business and Personal Letter," this document describes how the business owner would like the affairs of the company handled as well as who will handle which tasks and how the owner's family will interact with the business. Important decisions such as hiring and firing, taking out loans, and access to passwords should be spelled out in detail. The death or disability of an owner is an emotionally jarring event for both the family and the employees. The best remedy from a business perspective is to have a clear idea of how the business should be run in the months following such a tragedy.

6. Buy-Sell or Stock Purchase Agreement: As discussed in detail in the last section, when there are multiple owners there needs to be a document that discusses what happens to an owner's share should a trigger event occur. In reading these documents over the years, death is always covered but the document should also have contingencies for the following trigger events: disability, divorce, personal bankruptcy, termination, and retirement. Consider a family business where the parents had to terminate the daughter for substance abuse issues

3 The author has seen both ways work but it is important to allow the family to decide how best to educate younger members so encourages advisors not to insert themselves unless the family specifically asks for their help or the advisor sees a problem they can help correct.

and without a provision in their buy-sell agreement for termination, the daughter would have continued to be an owner and receive distributions even though she was no longer working in the business.

The protection of family assets and family net worth is a critical step in an estate and tax planning engagement with a business owner and their family. Further, as highlighted in the example above, it is important for us as practitioners to look beyond the immediate client (in this case the business owner) for potential issues with related parties. Consider the story about the minority-owner son who had no estate planning documents and his ownership in the family business with no buy-sell agreement. The son had no estate planning documents and the business had no buy-sell agreement. If these risks were not discovered and mitigated, what would happen if the son were to die or get divorced? For family businesses, keeping the business in the family can be of paramount importance and it is the advisor's job to help the family understand the risks to their current structure and provide solutions to mitigate these risks.

Passing Values to the Next Generation

For many business owners, the values they embody, such as hard work, honesty, and problem solving, are the key to their success. Further, they would like to pass these values to their children and grandchildren so that the family can continue to benefit from owning the business for years to come. However, in dealing with families, it can be challenging for the current owners to get through to the younger generations – whether because of a lack of communication or because the style of the message does not resonate. Therefore, it is important to provide strategies for helping these families build resilient educational frameworks in addition to financial security.

When working with families who not only want to transition business ownership but also want to pass down values and knowledge, one of the best practices is to set up a Family LLC and fund it using a mix of cash from a buyout, marketable securities, and/or a small interest in the family business. The LLC will have an age criterion for entry as a member so that children are old enough to understand the purpose of the LLC and to be able to participate in discussions about the management of the LLC's assets. In terms of ownership, the LLC will be structured so that the eldest generation has a majority interest because it is generally the older generation who has funded the LLC with assets. Over time, the voting rights and the ownership percentages will be adjusted so that the older generation's interest decreases while the younger generation's interest increases.

In many situations ownership transfer takes place over a period of years and the business' legal documents are updated but the personal estate documents are overlooked.

The benefit of setting up the Family LLC is that it allows the grandparents and parents to teach prudent asset stewardship through real life examples. For example, a board should be set up that includes members from each generation (e.g., grandparent as president, parent as treasurer, and grandchild as secretary). Depending on the size of the family, the board may want to have staggered two- or three-year terms so that different members can have a chance to serve. The LLC will have quarterly or semi-annual meetings where the members will discuss their asset allocation strategy, potential sales or purchases of assets, and overall strategy. These discussions can either be internal among family members or can be facilitated by an independent third party[3].

At the end of these board meetings, the family may be at a point where they can vote on the appropriate next steps, or they may want to continue discussions at the next meeting. Regardless, the secretary will distribute the minutes of the meeting and the Board will summarize the agenda for the following quarter. The formality is important to making sure that the LLC provides a real-life teaching tool to help the family grow its net worth and engender strong values even when the founding generation is no longer around.

Conclusion

Preparing any family for an intergenerational wealth transfer requires a lot of coordination and communication. It becomes even more important when the family owns a business that they plan to transition as part of their wealth creation strategy. When talking to prospects or presenting to business owners, the key message to them is to start early, know the transition options, and be transparent with communication.

The practitioners' job is to educate the owner and their family about the transition process, starting with the emotional challenges. The authors are currently working with a few clients who began their succession planning journey talking about how 2020 wore them down and how nice it would be to reduce the stress and time commitment that goes with running a business. However, when progressing toward their ownership transition, they have dug their heels in and begun to create barriers to progress such as "no one can do what I can do for this business" and "I'm not really sure I want to turn over control."

When at an impasse, it helps to slow down the forward progress and be empathetic but truthful. For example, "I can only imagine how hard this is for you and you are correct that no one will run the business like you because the next owner is not you; however, that does not mean you cannot teach the new owner the values that have made you successful so that they can continue your legacy." Repeating in a caring but firm way can help break logjams and allow the owners to make important decisions on their own.

These impasses are a normal part of the emotional roller coaster that owners go through when they are transitioning to a post-ownership life. For years the business has defined who the owner is to their family, to their community, and most importantly, to themselves. The thought of not having the business to define them is scary and can lead to intense and defensive reactions. The advisor's role at this point is to be an empathetic coach; to understand that the transition of a business can be like a grieving process. It will take time for the business owner to process their emotions and until they are ready to move forward, the best advice is to give them space but continue to educate and communicate with the owner, their family, and the important internal and external stakeholders. Regardless of the owner's current emotional state, the business will transition ownership. The only question is whether that transition will be a proactive transition driven by the owner's concrete goals for preserving their family's net worth and their legacy in the community or if the transition will be forced on the family and community by the death or incapacity of the owner. ■