CREATING A COMPREHENSIVE FINANCIAL PLAN

Handling succession and wealth transfer planning decisions for your family business

As a business owner, you face myriad decisions every day; decisions that affect the future of your family, as well as your business. Not only do you face the challenges of running your business today, you also must anticipate future challenges related to business and management succession, estate taxes and liquidity, death and disability. These challenges take on even greater importance when your business comprises a significant portion of your family's wealth.

Fortunately, timely planning can effectively address these concerns, protecting both the business and your family.

PREPARE FOR THE UNEXPECTED

Perhaps the first issue you need to prepare for as a business owner is the possibility of becoming disabled or incapacitated. Even if you are healthy and young, having a plan for how the business will run if you become disabled is crucial. One in four[1] of today's 20 year olds will become disabled before retirement. In addition, an illness or accident will keep one in five people out of work for at least a year during their careers.

For you, as a business owner, this can be doubly devastating. Not only could you face a loss of income, your disability also could cause a serious disruption to the business, including loss of customers as well as valued employees. To protect your business and your family, you should create a comprehensive plan to cover the management of your business and your potential loss of income.

IMPORTANT ISSUES FOR FAMILY BUSINESS OWNERS TO ADDRESS

1. What will happen to the business and your family if you become incapacitated or die unexpectedly?
2. Does your family want to sell or retain the business?
3. Should you sell or transfer the business to your children now or later?
4. How much is the business worth?
5. Do you have partners or employees who may want to buy your interest?
6. How will you manage estate taxes?

This plan will allow you to prepare for an orderly continuation of business if you should become disabled — either temporarily or permanently. To be most effective, you will want to work with your advisors and board of directors to create as seamless a transition as possible and to be sure everyone agrees with and understands your plan.

1 U.S. Social Security Administration Fact Sheet, February 7, 2013.

On a personal level, you may want to consider disability insurance to cover the loss of income (both from salary and any decline in business your company may face in your absence). If you are not the sole owner of your business, you also may want to discuss with your advisors such techniques as creating a revocable trust that would transfer responsibility for voting your equity interests to a successor trustee while you are unable to make decisions. Or, you might consider using a durable power of attorney. Having a plan in place will allow your family to avoid expensive and public (and potentially demeaning) guardianship proceedings.

DEVELOP YOUR EXIT STRATEGY EARLY

Whether you plan to retire early or run your business until your death, eventually someone else must take control. Businesses that have a blueprint for the future are not only less likely to fail, but they are also more likely to retain their value, now and in the future.

Focusing on succession planning and developing an exit strategy can be difficult, especially when you are working to make your business grow. But successfully transferring business ownership while minimizing the tax consequences takes time. This is true whether you plan to transfer ownership to your children, an employee or an unrelated party. Identifying and training your successor to manage the business can be time consuming as well. The earlier you begin planning your exit strategy, whether you plan to continue running the business for five years or 50, the smoother the transition eventually will be. Having a plan in place helps protect you from the unexpected, gives you time to share your plans with your family and employees, and allows you to work with your advisors to minimize the tax consequences of the eventual ownership transfer.

DETERMINE WHETHER TO KEEP THE BUSINESS IN THE FAMILY

A good place to start your succession planning is to determine whether you – and your children – want to keep the business in the family. To do this, consider both your own goals and priorities and those of your children. Your children might have other career goals and may not be interested in the business, or they may not have the aptitude to run a company successfully. Of course, ownership and management don't necessarily have to remain linked. Depending on your family circumstances and your company's situation, you may find separating ownership succession from management succession is appropriate.

Several questions may help you assess whether passing the business to your children is the best solution:

- If your children currently are active in the business, do they want the responsibility of owning it?
- Would the business continue to prosper under their ownership?
- Financially, is passing the business to your children – either through a sale or gift – the best option for you?
- Would selling or giving the business to only one child cause conflict with your other children or with your spouse?
- Will the transition time needed to successfully transfer your business to a child keep you involved longer than you would like?

DECIDING WHEN TO SELL

Deciding whether to sell your business during your lifetime or to retain ownership until your death can be a difficult decision. On the one hand, selling during your lifetime can give you more control over the process and help you feel confident your family will be taken care of. On the other hand, selling during your life means giving up control over the business you've worked so hard to build.

Here are some questions to help you make the decision:

- Will your family need the proceeds from the sale to maintain their style of living after you are gone? If you have little or no income diversification, you will leave your family dependent on the sale of the business.
- Does a ready market exist for your business? If you know a strategic buyer or competitor is interested in the business, you may feel more comfortable waiting to sell.
- Is your business in saleable shape? If you have a lot of unrelated or unprofitable lines of business on your balance sheet, it may be harder to find a buyer.
- Does your family have the capacity to manage the business during the sale period if you choose to retain the business until your death? If not, do you have a management team in place that can quickly take over running the business?

The answers to some of these questions may indicate that, for you, selling the business to an unrelated party might be a better financial or emotional decision.

If transferring ownership to your children seems to be the best approach for your business, you still have to do some groundwork to ensure a successful transition. This is particularly true if not all of your children are interested in being a part of the family business. Laying the foundation for a transition of ownership and management is best done while you are still active in the business and can provide insight and guidance during the transition period.

Before Transferring Ownership, Transfer Management to Your Children

If you plan to transfer ownership of your family business to your children, don't overlook developing a management succession plan to provide your child (or children) with experience in the day-to-day management of the business.

By allowing your child to assume management responsibility gradually, you will:

- Provide your child credibility with nonfamily employees, vendors and customers;
- Give your child time to make mistakes and learn from them, without causing material harm to the business; and
- Allow yourself time to evaluate the child's ability to succeed in a senior management role.

While many succession plans focus on reducing the parents' estate taxes, providing for the ongoing growth and success of the business is also critical.

Handling Ownership Transition When Only One Child is Involved in the Business

If you have multiple children, but only one child is involved in the business, you need to take extra steps with your business succession and ownership transfer plans to avoid disharmony and resentment. Leaving the business to all your children equally, regardless of their involvement, may seem like a simple solution to this problem. Equal ownership, however, may create hopeless deadlock and cause sibling conflict.

On the other hand, providing the active child with a larger stake in the company, and therefore giving him or her control, also can cause problems. Your children who aren't involved in the business may have different goals and ideas about management than the child who is, leading to frustration and resentment.

BUILDING A FAMILY BUSINESS SUCCESSION PLAN

Harriet, who is divorced, owns a thriving landscaping business, which she runs with the help of her daughter Monica. Her other three children are professionals living in other cities. Although Harriet plans to pass the business on to Monica, she wants to provide for her other children as well.

With her objectives firmly in mind, Harriet set up a meeting with her estate planning attorney and her accountant. They began to work together on a family business succession plan under which Monica will own the business at Harriet's death. They evaluated various transfer strategies and chose the strategy that worked best for Harriet and her family.

On the recommendation of her planners, Harriet sat down with each of her children and had a frank discussion about her plans to pass the business to Monica. She also explained her plans to ensure they are all taken care of. As a result, Harriet's children feel they are each being treated fairly and agree that Monica should have the business.

By working with her advisors to create a family succession plan and discussing the plan and her intentions with her children, Harriet has avoided what could have been a bitter family conflict.

A third option is to sell the business at market value to the child who is active in the business, or provide an option to the child to buy the business at an agreed on price at your retirement or death. Because the child is paying for the business, rather than receiving it as a gift or inheritance, this should minimize complaints from the other children.

If you would prefer to transfer the business to the working child as a gift, you can balance this gift by leaving other assets of equal value to each of your other children. Life insurance can help provide the needed liquidity to balance the value of the business with bequests to your other children.

When More Than One Child is Active in the Business

If you have two or more children involved in the business, take the time now to help them work out a system to amicably resolve business disagreements. One way to do this is by allowing your children to begin making management decisions together now, while you are still involved in the business. This will allow you to observe how they work together and provide suggestions to help resolve any disputes that may arise.

SELECTING THE BEST METHOD TO TRANSFER OWNERSHIP

If you decide to transfer ownership of the family business to your children, you need to determine the best method for making that transfer. Many planning techniques can help you minimize the tax burden you'll face, depending on whether you plan to transfer ownership during your lifetime or at death.

Transferring interests to family members during your lifetime (inter vivos), rather than at death offers several advantages: it allows you to reduce estate taxes and may also provide you with cash flow to fund your retirement. A variety of tax-efficient methods are available for transferring ownership interests to your family, each with different advantages and disadvantages.

Some of the options you may want to consider with your advisors include:

- **Using a grantor retained annuity trust (GRAT).** This strategy involves transferring ownership interests to the GRAT in exchange for annual payment of an annuity to the grantor (you) in cash or in kind for a specified number of years. When the GRAT terminates (typically after an agreed on number of years), the remaining assets are distributed to the designated beneficiaries (your child or children, either outright or in trust).

  Taking advantage of certain disparities between the Section 7520 rate and the growth of the business, ownership interests can be transferred to the next generation with minimum gift tax liability. Depending on a number of factors, including the structure of the GRAT and the disposition of voting rights associated with the company stock, a parent could transfer minority interest(s) in the business while retaining voting control. If you die during the GRAT's term, however, part or all of the assets in the trust will be included in your estate.

- **Following a program of making annual gifts.** By taking advantage of the annual gift tax exclusion and the lifetime gift tax exemption, you can create a planned giving program that could allow you to minimize or even avoid incurring any gift tax liability. By making annual gifts to each of your children up to the current annual gift tax exclusion amount allowed, you can transfer ownership gradually without incurring a tax liability. In addition, you could make use of your lifetime gift tax exemption to make a larger, one-time gift of shares.

  You could further leverage this technique, and retain voting control, by recapitalizing your company stock into voting and nonvoting interests. Because they are worth less, the nonvoting interests will have a lower value, allowing you to transfer more shares each year without incurring gift tax. In addition, because you keep the voting shares for yourself, you can transfer ownership even before you are ready to transfer control.
- **Using an intentionally defective grantor trust (IDGT).** Using this technique, you sell a minority interest in the business to a trust (which has been carefully drafted to maximize its tax effectiveness) in exchange for a promissory note. With an IDGT, you will continue to pay income tax on the assets held in the trust, but their value will be removed from your estate, reducing your eventual estate tax burden. By continuing to pay the income taxes yourself, rather than using trust assets to pay the taxes, you increase the eventual value that will pass to your heirs. In addition, because you are giving minority interests in your business, you will be able to transfer a larger number of shares without incurring gift taxes, and you will benefit from an annuity stream from repayment of the note.
- **Creating a family limited partnership (FLP).** This technique requires creating an FLP and transferring ownership of the business to it. By making use of your annual gift tax exclusion and your lifetime gift tax exemption, you can give your children limited partnership interests while minimizing your gift tax liability. As the general partner, you would retain control over the business. However, to avoid incurring estate taxes, you will need to transfer the general partnership interest during your lifetime. Otherwise, a portion – or all – of the partnership's assets may be included in your estate.

Depending on the circumstances, you may be able to combine these techniques to achieve your desired outcome. Be aware that some of these techniques have a higher risk of challenge by the IRS than others, which may result in additional taxes, interest and penalties. You will want to carefully weigh the advantages and disadvantages of each technique with your estate planning attorney and other advisors.

WHAT IS A FAMILY LIMITED PARTNERSHIP?

A family limited partnership (FLP) is a sophisticated financial planning technique that, if implemented properly, allows a family to hold and manage its wealth, including the family business, with several generations of family members as partners.

An FLP has two classes of partners: general partners have control over the day-to-day operations of the business; limited partners are not involved in business operations.

SELLING TO PARTNERS OR EMPLOYEES

If your children are uninterested in taking over ownership of your business, you may want to consider the possibility of transferring ownership to an insider – either a business partner, if you are not the sole owner of your company, or to an employee or group of employees. Particularly if it is important to you that the business continue after you are gone, selling to an insider may provide a ready buyer who already understands the company and may be more committed to continuing the business than an outside buyer.

Buy-Sell Agreement with Current Partners

If you hold an interest in a multi-owner corporation, limited liability company, limited partnership or other type of business with two or more owners, your partners are likely to want to continue the business when you die or decide to retire. Buy-sell agreements – an agreement between owners that establishes terms for buying each other's shares of the business in the event of death, disability or retirement – can simplify this process and ensure the funding is in place to make the transfer.

A buy-sell agreement offers three key benefits:

- It provides a ready market for your shares at your death or disability.
- It sets a price or determines the method to be used for pricing the shares. In the right circumstances, it also fixes the value for estate tax purposes.
- It provides for business continuity by avoiding unnecessary disagreements and lengthy negotiations.

Business owners typically fund a buy-sell agreement with life insurance. Alternatively, the surviving partner can buy the deceased partner's share of the company on financed terms.

Gradual Sale to an Employee

Many family owned businesses have an employee who has been with the company for a long time and contributed substantially to its successful operation. This person may be interested in becoming a partner in the business and buying your shares when you plan to retire.

Before taking on an employee-partner in your business, ask yourself:

- Can you comfortably share managing the business with your new partner?
- What if the co-ownership doesn't work out? Can you buy back your interest? If so, at what price and on what terms?
- What if your employee dies, becomes disabled, goes bankrupt or divorces?
- When will managerial control shift to your employee?
- What safeguards do you have against being forced out of the business?
- When can you or your employee trigger the complete buyout of the business?

KEEP IN MIND:

- If you hold an interest in your business at your death, your estate may owe estate tax on the value of that interest.
- Congress has drafted tax laws that distinguish between bona fide business arrangements and schemes that attempt to put form over substance. For example, a purported buy-sell agreement that transfers stock to family members at below-market values will be disregarded for purposes of determining the value of the stock for estate or gift tax purposes.

Working closely with your advisors can help you create an agreement that provides the safeguards you need to protect your interests, while allowing your employee to eventually buy your interest in the business. Before moving forward, however, you must be confident the employee will be able to complete the purchase and successfully run the business thereafter. This is particularly important if you are to finance the sale.

Selling Shares Through an Employee Stock Ownership Plan

Sale of closely held stock to an employee stock ownership plan (ESOP) continues to be a popular exit strategy for many business owners, offering potential liquidity, flexibility and tax efficiency. ESOPs also provide much greater flexibility in terms than a sale to management or an outside buyer would provide. With an ESOP, for instance, you can:

- Elect to sell the entire business at once or structure the sale to take place over a number of years.
- Structure the sale as a cash sale or an installment sale.
- Defer income tax on the sale through the use of specific tax rules.

An ESOP also can provide liquidity for minority owners, which might be more difficult to otherwise find. In addition, many companies experience an increase in productivity after establishing an ESOP, as employee-owners have new motivation to see the company perform well.

Although the rules for establishing an ESOP are complex – you'll need to work with your wealth transfer team on the required technical compliance – the rewards can be great.

SELLING YOUR BUSINESS TO AN OUTSIDE BUYER

If you decide your best option is to sell your business to an outside buyer, you will need to prepare the business for sale and find an interested buyer, both of which can take time. While you can choose to retain ownership of your business until you die, selling your business during your lifetime gives you more control over the process and can help you make sure your family will be taken care of.

When you sell the business during your lifetime:

- You can work with your advisors to control the process and feel confident you are receiving the best price for your business.
- You can invest the proceeds for the benefit of your beneficiaries. If you are older or if your health is declining, this may be preferable to the possibility of a distressed sale later.
- You know the business's value and can develop your estate plan accordingly.

TRANSFERRING VALUE, MAINTAINING CONTROL

Josh owns a successful construction business, which he is planning to sell in the next five years. His adult children are not interested in running the business and he has no obvious successors among his employees. While Josh would like to shift much of the value of the business to his children, he also wants to maintain control until he is ready to sell.

Working with an estate planning attorney, Josh recapitalized the company into voting and nonvoting shares. He sold some of the nonvoting shares to trusts established for each child and retained the voting shares himself. By doing this, Josh was able to maintain control of the business while transferring shares of the company, which will continue to grow in value, to his children. When Josh sells the company, he and each of his children have the potential to receive full value for their shares.

Because family owned businesses are not publicly traded, their exact value can be difficult to determine. Regardless of whether you choose to sell the business during your lifetime or at death, you should include a formal appraisal in your planning process.

PURSUING PRIVATE EQUITY

Private equity firms provide another option for business owners looking for an outside buyer. Your business may make a good target for a private equity firm if it has solid earnings and growth prospects, a unique niche and a strong management team that will stay involved. Private equity firms also typically pursue companies with a similar line of business to their existing portfolio.

A potential benefit of a sale to a private equity firm is that it may provide you an opportunity to continue running the company even after selling your ownership interest. If you do stay on to run the company, however, you no longer will have sole decision-making authority. If you don't think you'll be comfortable taking direction from someone, you may find selling to a private equity firm is not a good fit for you.

If you are considering a sale to a private equity firm, be sure to work with your advisors to position your company appropriately and to create a deal that will help you meet your goals.

CONSIDERING ESTATE TAXES

A successful business can trigger substantial estate taxes. To protect your business and your family, you will need to consider the effect estate taxes will have on your long-term plans.

Plan Early to Minimize Your Liability

Fortunately, taking the time to create a wealth transfer plan can go a long way toward minimizing your ultimate tax bill and can help you create a strategy to meet your estate tax obligations without jeopardizing your other long-term plans. The key is to work with your advisors to create a plan in advance.

To help protect your family:

- Have a qualified appraiser determine the business' value at regular intervals. Over- or undervaluing your business (or any other substantial assets) can significantly affect your estate tax liability. Having an up-to-date valuation of your business will allow your advisors to adjust your estate plan to cover your potential tax liability.
- Discuss with your advisors whether your estate will qualify for installment payments. If your estate meets certain requirements, your executor or trustee can choose to pay the federal estate taxes resulting from business ownership over a period of years.
- Determine if your executor or trustee will have enough cash or liquid assets to pay the estate taxes on the business. If not, investigate buying life insurance to cover the expense. Alternatively, consider removing some of its value from your estate by making lifetime gifts of the business to your children or charitable trusts.

Use Insurance to Maintain Liquidity

Unfortunately, liquidity frequently is an issue for business owners, who often have a large portion of their net worth tied up in the business. Without sufficient liquidity, your estate may be forced to liquidate assets at substantially less than market value when estate taxes come due nine months after your death.

For this reason, life insurance can play a valuable role in estate planning. For instance, an astute business owner can use life insurance to provide:

- The liquidity your family needs to pay estate taxes and administration costs without having to sell the business.
- Funds to cover living expenses for your spouse or children.
- Funding for a buy-sell agreement to purchase a partner's interest in the business.
- A bequest to children who are not involved in the family business to balance the gift of the business to the child who is involved.

WHAT IS AN ILIT?

An irrevocable life insurance trust (ILIT) is an irrevocable trust that holds an insurance policy on your life. When you die, benefits are transferred directly into the trust and, if properly structured, are not included in your taxable estate. Therefore, an ILIT can greatly increase the amount beneficiaries receive.

As with other irrevocable trusts, an ILIT requires a written document, a trustee, beneficiaries and detailed terms. The ILIT trustee follows your directions, as set forth in the trust document, regarding payment of insurance premiums during your lifetime and payment of insurance proceeds to the trust beneficiaries upon your death.

If you own an insurance policy on your life, the proceeds will be included in your taxable estate when you die. To avoid owing estate taxes on the proceeds when using life insurance to meet your estate planning needs, you may want to consider using an irrevocable life insurance trust (ILIT) to own the policy. A properly drafted trust can allow you to remove the proceeds from your estate (if the trustee of the life insurance trust takes out the policy initially or you survive beyond three years from the transfer of existing life insurance to an ILIT) and avoid having to pay estate taxes on them, thereby passing a larger amount to your beneficiaries. (If you do die within three years of transferring an existing life insurance policy to an ILIT, the proceeds will be included in your taxable estate.

Alternatively, you can name another individual or entity, such as your children, your spouse, your business, a family limited partnership or a limited liability company, as the policy owner. If you name your spouse as the owner of the insurance policy, the proceeds may be subject to estate tax at your spouse's death.

Figuring out who will own the life insurance policy and the income, gift and estate tax consequences of any transfers should be done in consultation with your attorney or tax advisor.

If your primary goal for the life insurance policy is to pass wealth to your children, it may make sense to name the children as owners. If so, the proceeds will not be subject to estate or income tax when you die. As the owner, however, a child can make him or herself the sole beneficiary. Such authority may be problematic if the child is not financially responsible.

USING YOUR BUSINESS TO PROMOTE FAMILY PHILANTHROPY

Whether you want to give back to the community that helped your business grow or because you feel passionate about a specific cause, you may see philanthropy as an important part of your legacy. Philanthropy not only benefits the community and the organizations receiving your donations, it also can help bring your family closer. One way to do this is by creating a private foundation.

Today, more than 70,000 grant-making private foundations exist in the United States. Unlike public charities, private foundations are supported by a very limited number of donors – typically a corporation or an affluent family. More than half of all private foundations are family foundations, controlled by individual donors and their descendants, advisors and friends. The income tax charitable deduction for lifetime transfers to private foundations is limited by the "percentage of adjusted gross income" rules. Gifts of cash are subject to a 30% limitation; gifts of publicly traded stock are subject to a 20% limitation.

Because real estate or shares of closely held stock are considered long-term appreciated assets, your income tax deduction generally would be limited to your cost. For this reason, most lifetime transfers to private foundations are funded with cash or publicly traded stock. However, if you want to establish a private foundation, you could use proceeds from the sale of your business (cash) to do so. Alternatively, you could opt to fund your private foundation at death, taking advantage of the unlimited estate tax deduction, regardless of the type of asset transferred.

Despite their complexity, family foundations can allow you to foster family unity and promote a tradition of giving. After establishing your foundation, you can involve your children on the board or a junior board to help with the grant-making process.

Sometimes, however, family discord can arise if family members support widely disparate charitable endeavors. To minimize conflict, some families choose to set up individual foundations for each of their children, allowing each child to make grants to the types of organizations he or she chooses to support.

TAXATION AND PRIVATE FOUNDATIONS

Although private foundations are exempt from income tax, most pay a 2% excise tax on their net investment income, including capital gains. Private foundations also are subject to a variety of penalty taxes designed to ensure that donors do not benefit, directly or indirectly, from the foundation's assets and income.

One downside of a private foundation is its administrative complexity. For example, tax rules require annual distributions equal to at least 5% of average monthly asset value, with a 30% penalty tax on late payments. Private foundations also are subject to complex rules on self-dealing, excess business holdings, jeopardizing investments and excess expenditures, all with associated penalty excise taxes.

To keep their foundations legally compliant, donors typically turn to their accountants or a financial services provider who will serve as agent or trustee.

PLANNING TO PROVIDE YOUR FAMILY PEACE OF MIND

Your family business reflects your family's values, your hard work, and provides you and your family with income and security. By taking the time now to prepare an exit strategy and a wealth transfer plan, you can protect both your business and your family, and give yourself peace of mind.

If you would like to learn more about wealth transfer planning, contact your relationship manager, visit the nearest Northern Trust location or go to northerntrust.com.

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