

Transition by Design: Successful Succession of the Privately Held Business

Joint Meeting of the Chester County
Estate Planning Council and the Estate
Planning Council of Delaware

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Changing Paradigms

Business Succession Planning. . . and Yogi Berra

“It's like déjà vu all over again!”

- New “what ifs” on a fairly consistent basis
- NAEPC past president Jordon Rosen's article in NAEPC Journal of Estate and Tax Planning
- September 8, 2016
- Better to wait and see?

“When you come to a fork in the road – take it!”

- Plan – No matter which turn is taken, the path is clear
- Static documents interpreted in light of dynamic new law
- FLEXIBILITY
- Disinherit spouse or other beneficiaries?

“If you don't know where you're going, you wind up somewhere else.”

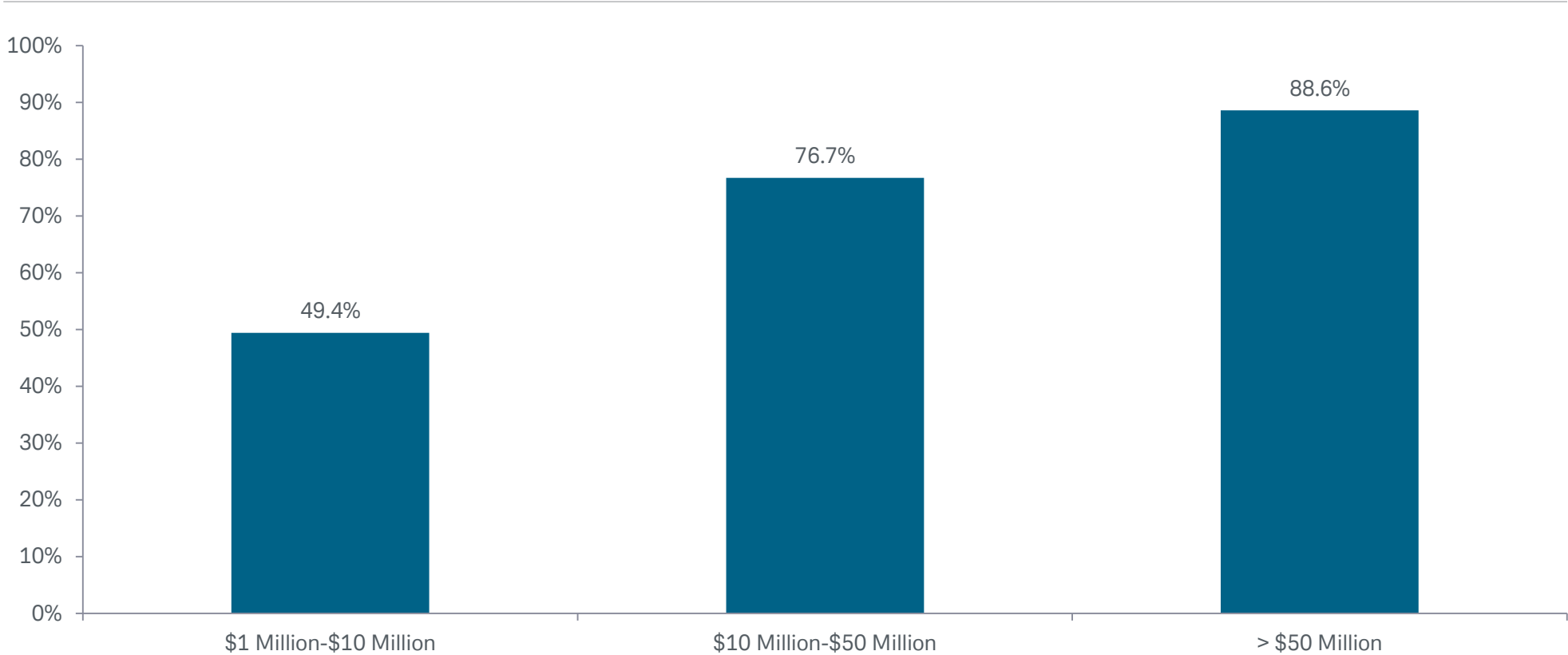
- Wealth in motion will be taxed!
- Income tax and basis planning – The New Black
- Capital gains tax
- State tax regimes

Source: USA Today – 50 greatest Yogi Berra quotes

A Changing Marketplace and Business Owner Demographics

Wealth Creation in the United States

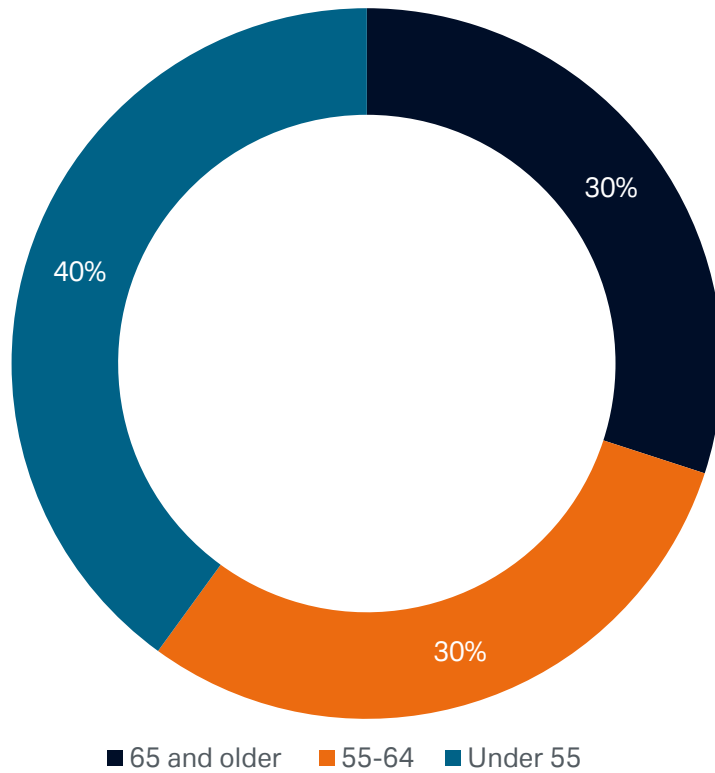
Percentage of Millionaire Households That Own a Private Business by Net Worth Tier¹



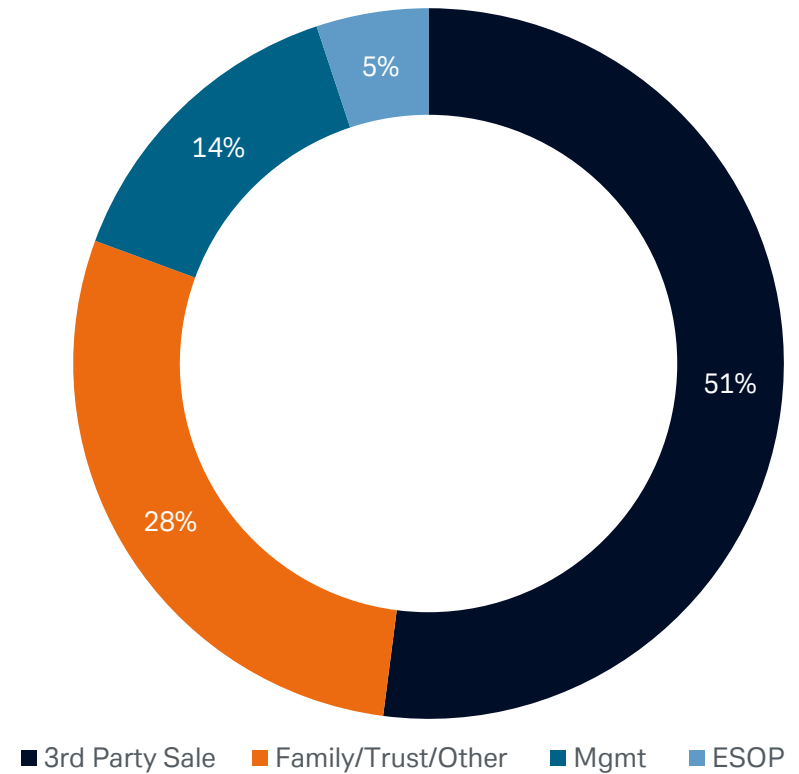
¹ Federal Reserve 2013 Survey of Consumer Finances. Shows a 1.6% decrease overall in Holdings of Business Equity Across Tiers since 2005.

Winds of Change

Business Owner Age



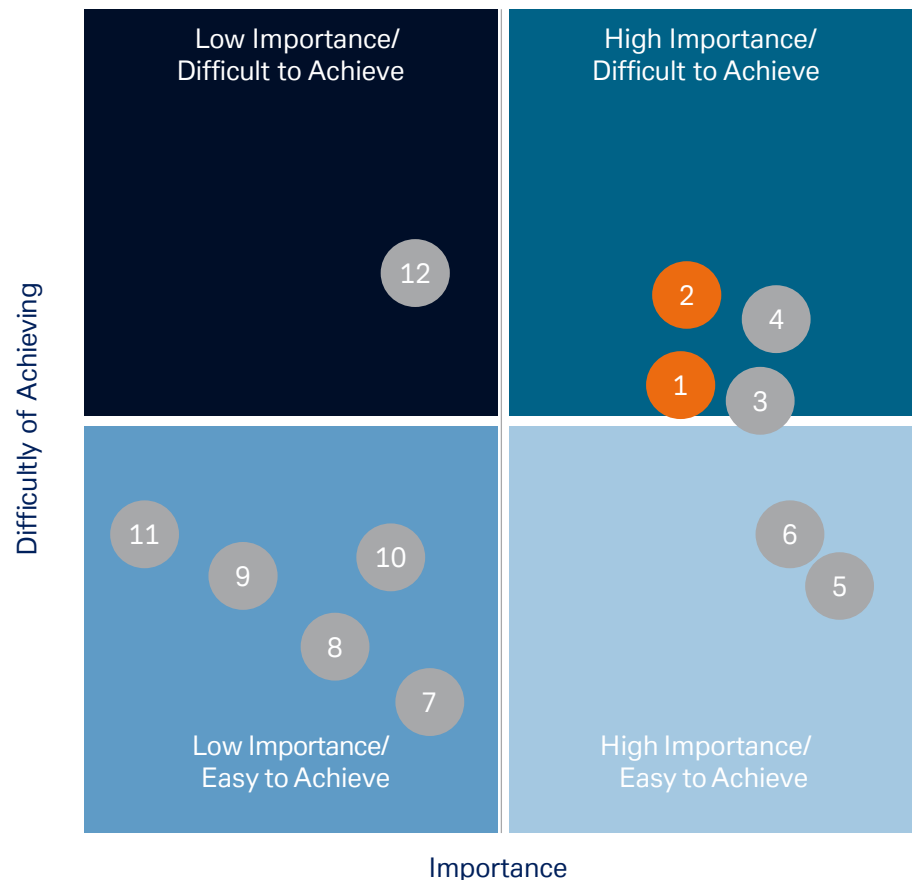
Ownership Transition



Source: New York Times "Are Baby Boomers Ready to Retire?" February 11, 2011.

Source: VIP Forum 2010 Survey of Business Owners

Mission Critical Issues of Greatest Importance and Difficulty for Family Businesses



- ① Resolving conflicts among family members who are in the business
- ② Formulating a succession plan
- ③ Developing a strategic plan
- ④ Developing a retirement and estate plan
- ⑤ Ensuring that the family's core business values are maintained
- ⑥ Financial growth plan
- ⑦ Compensating family members in the business
- ⑧ Bringing family members into the business
- ⑨ Ensuring family members benefit from owning shares
- ⑩ Bringing non-family executives into the business
- ⑪ Transferring wealth and equity to family members not involved in the business
- ⑫ Transferring wealth outside the business

Source: Grant Thornton, *Results of Family Business Survey*

Challenges Facing Family Businesses

- 85% of the crises faced by the family business is focused around the issues of succession.¹
- According to the Small Business Association:²
 - 90% of America's businesses are family owned
 - 30% make it to 2nd generation
 - 12% survive to 3rd
 - 3% reach the 4th
- Primary reason is failure to properly structure a succession plan³
 - 90% agree on importance of exit planning
 - 33% have a business succession plan
 - Only 29% feel their team of advisors is qualified to help

¹ Keeping it in the Family: Business Succession Planning; Charles D. Fox IV; A.L.I.-A.B.A. (2011)

² Challenges in Managing a Family Owned Business; Small Business Administration (SBA.gov).

³ VIP Forum 2012 Survey of Small Business Owners

Integrated Master Plan Design

The Process Driven Strategic Model and
Strategic Assessment

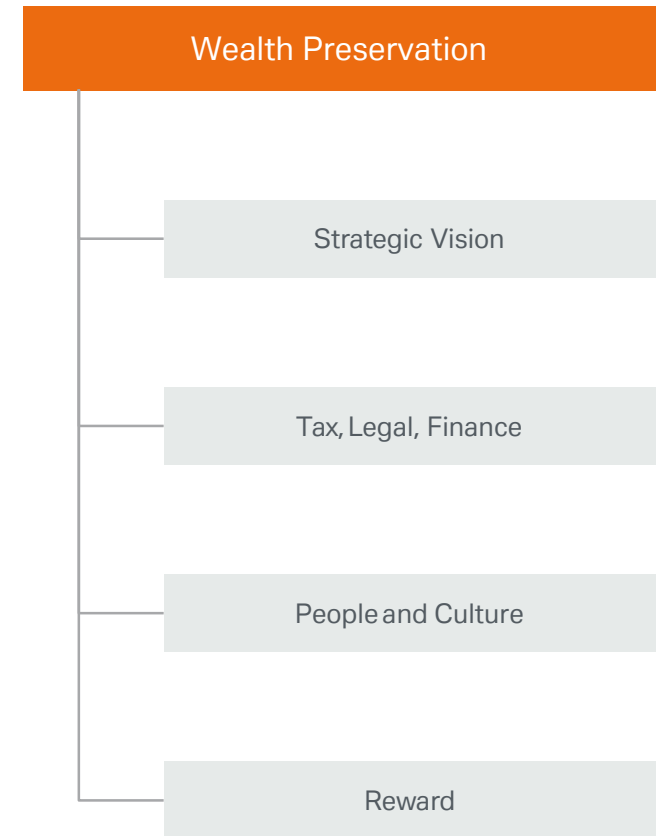
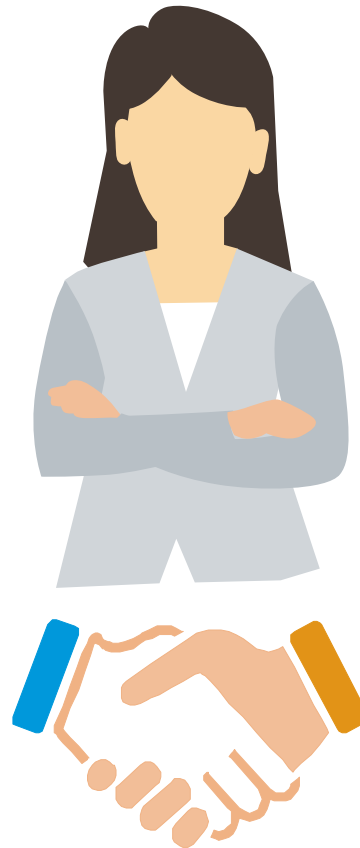
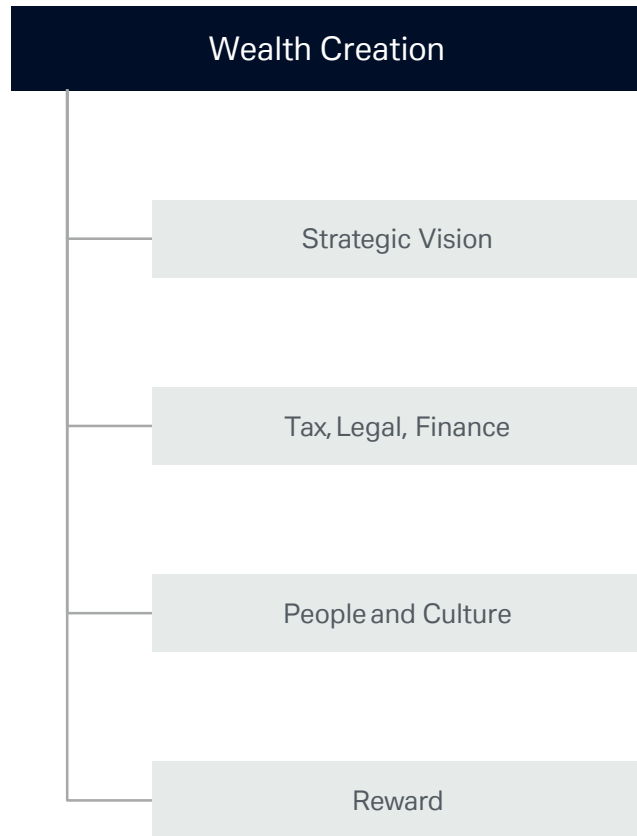
Transition by default can be a real juggling act. . .



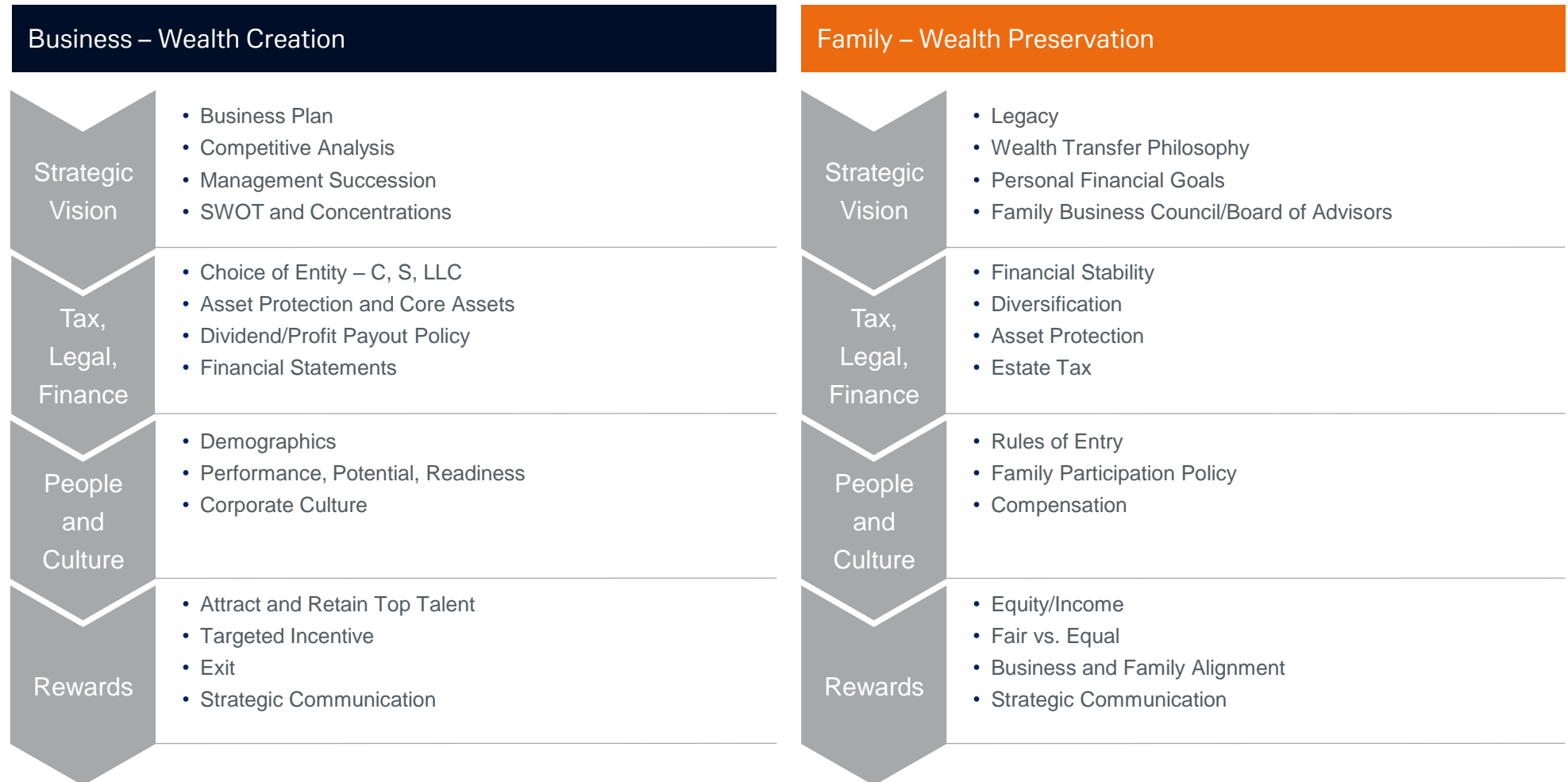
...with serious consequences



The Drivers – Business and Family Dynamics

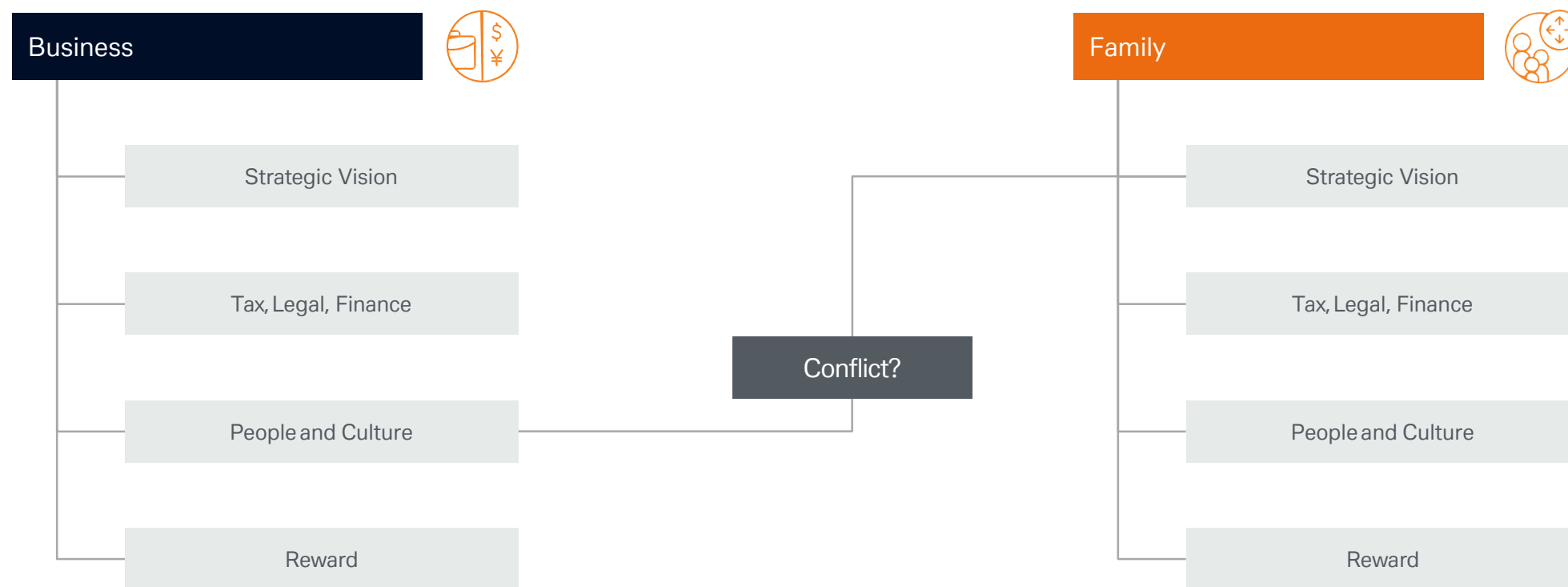


Strategic Assessment



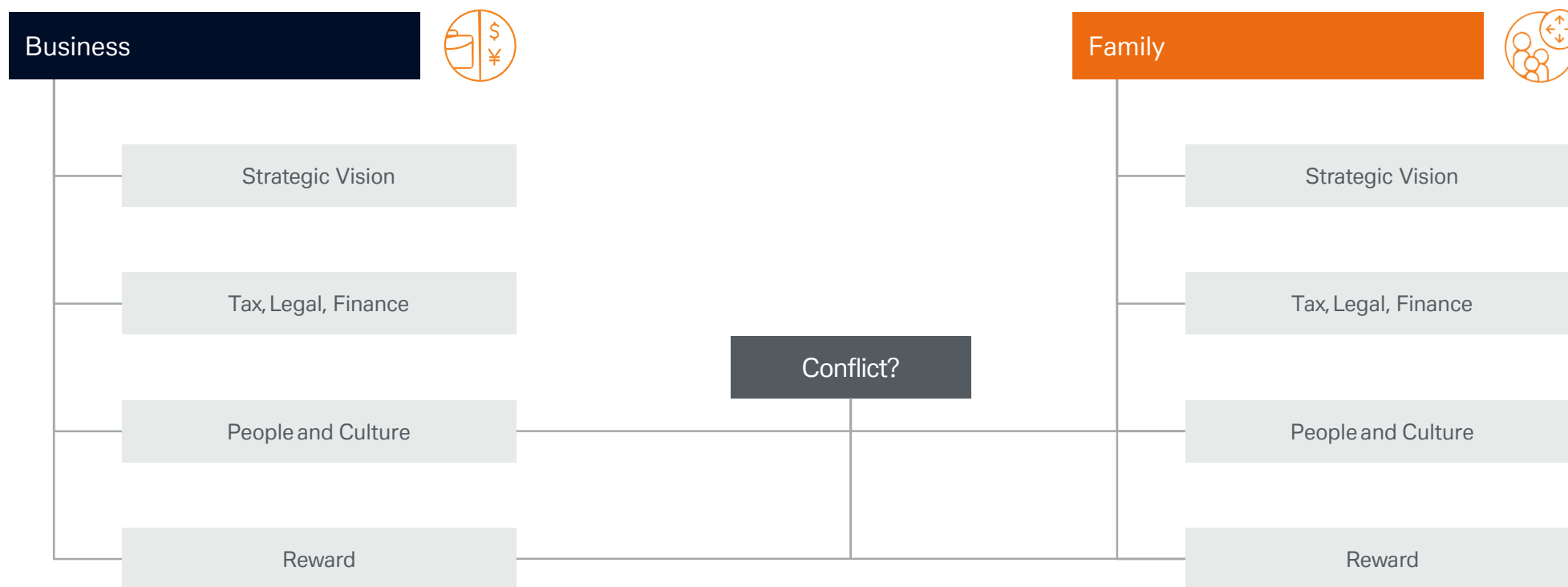
Final Phase: Resolve Conflicting Objectives – 1

- The owner of a family business envisions naming his son CEO.
- The CFO—a critical employee and NOT a family member—neither likes nor respects the son.
- In fact, the CFO, and others, will likely quit if the son is named CEO.



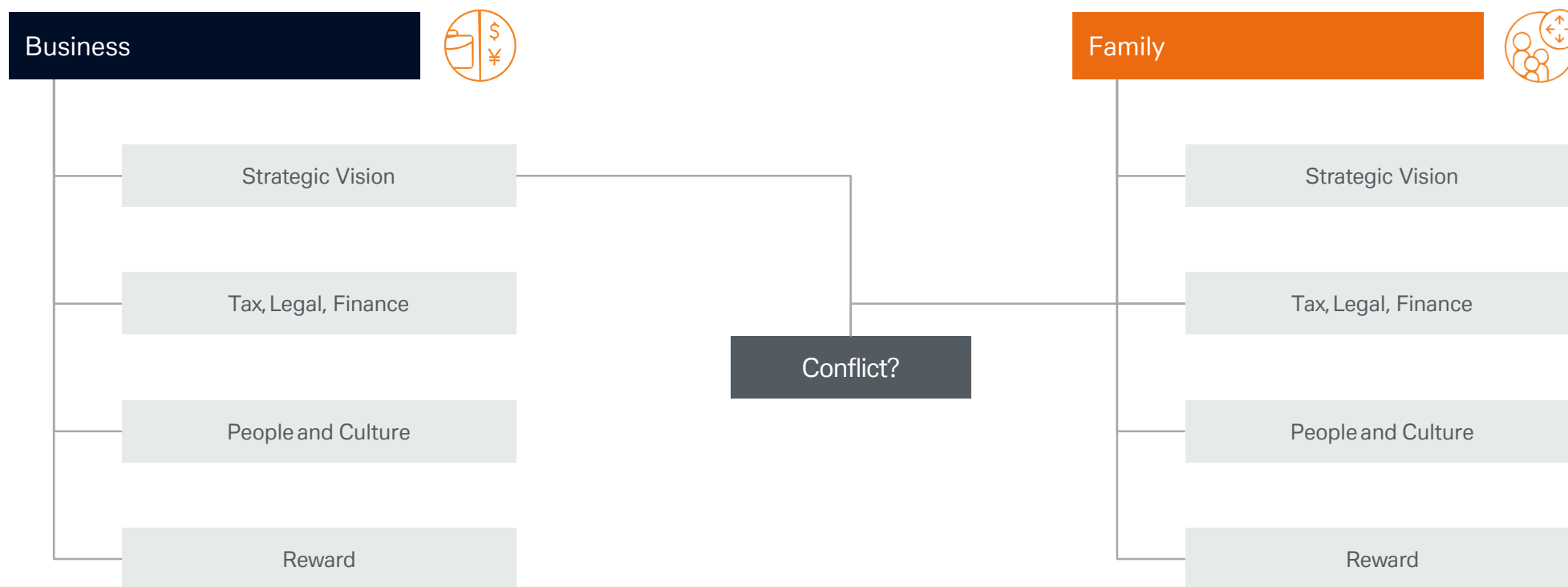
Final Phase: Resolve Conflicting Objectives – 2

- Kids in the family paid birthright v. market rate
- Non-family members know that family employees are being overpaid – they see cars, neighborhood, vacation, etc.



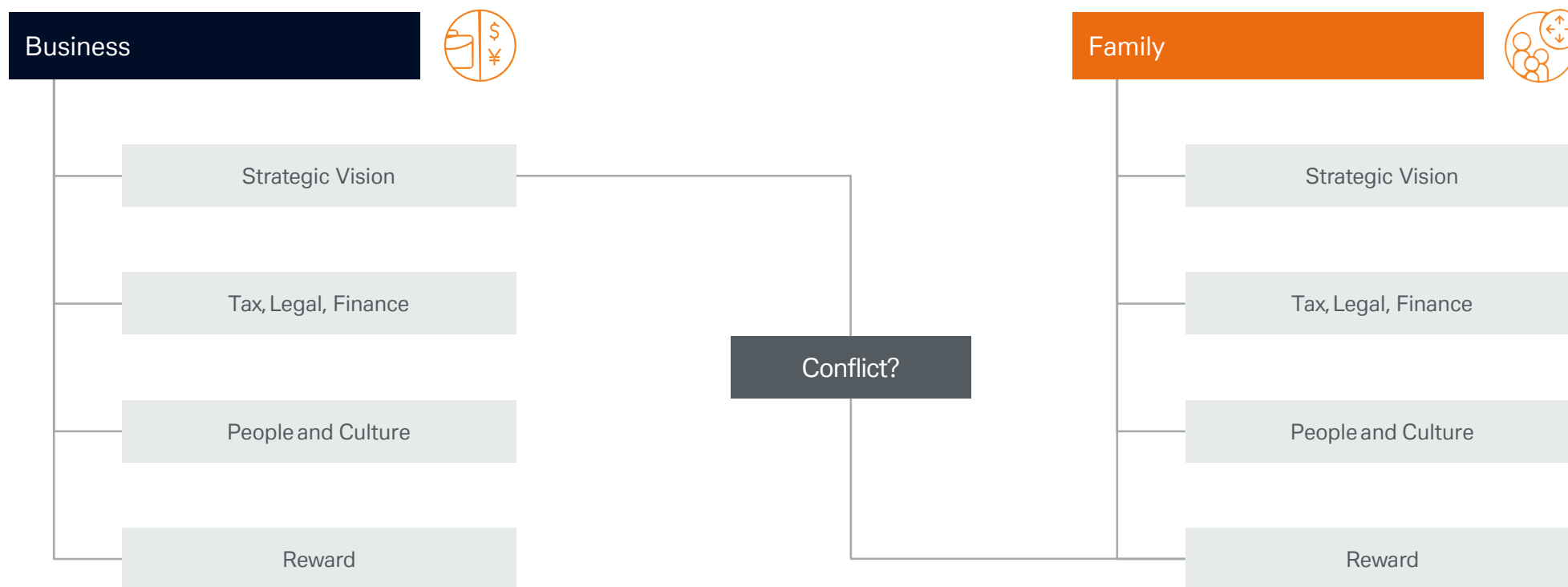
Final Phase: Resolve Conflicting Objectives – 3

- Business owner has a vision of growing the business but wants to retire soon.
- Growth will take cash
- Owner has liquidity needs at retirement.



Final Phase: Resolve Conflicting Objectives – 4

- Inactive family shareholders in business are frustrated with active family members being paid huge salary and receiving company car, while the inactives get low or no dividend
- Active kids say, “you are getting a free ride on my equity!”



Strategic Opportunities

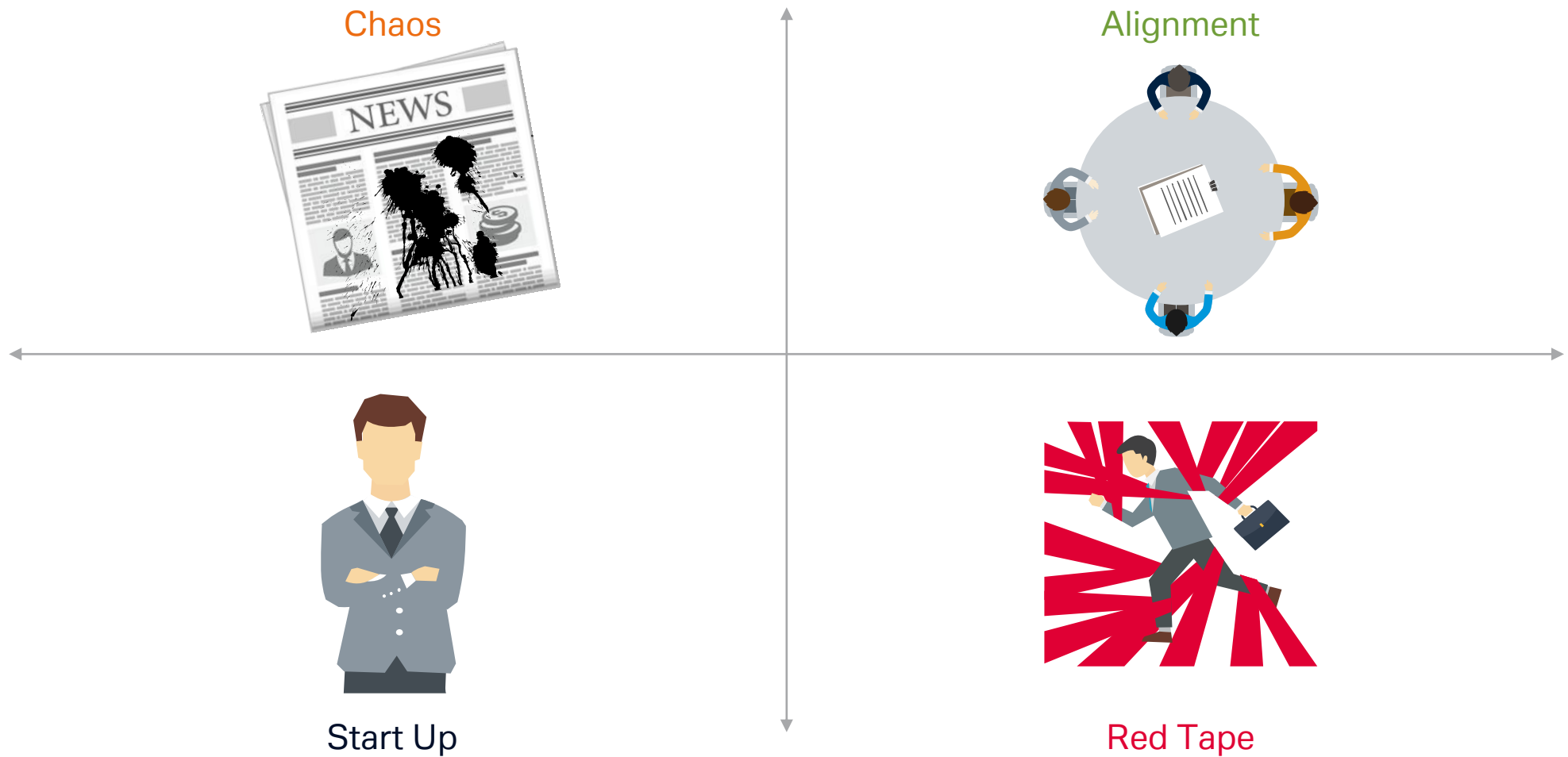
Know Your Numbers

Prevailing Factors

Amounts/Rates

| | |
|-------------------------------|--|
| Valuation Options | Strategic-Financial-Estate |
| Long-Term Capital Gain Rate | 20% |
| Qualified Dividend Rate | 20% |
| Top Income Tax Rate | 37% |
| Annual Gift Exclusion | \$15,000 individual/\$30,000 married ("Use it or lose it") |
| Lifetime/Death/GST Exemption | \$11,400,000 individual/\$22,800,000 married (portable) |
| Top Transfer Tax Burden | 40% |
| Additional Tax Burden | \$66,000/month (per \$20 million Taxable Estate @7.2%) |
| Applicable Federal Rate (AFR) | Low by historical standards |
| November 2019 Rates | AFR Short – 1.68%; Mid – 1.59%; Long – 1.94% & 7520 – 2.0% |
| Medicare Surcharge | 3.8% |

Evolution of a Business. . . .or De-evolution?



Strategic Opportunities: All In The Family

- **Create Financial Stability**
 - Take some chips off the table
 - Tax-free dividends
 - Diversify
- **Prepare for Management Succession**
 - Identify and groom an heir apparent
 - Design incentive to attract/retain/reward top talent
- **Establish Private Business Governance Model**
 - Family Business Council
 - Board of Advisors
 - Dividend policy

Strategic Opportunities: All In The Family

- **Classic Freeze**
 - Valuation discounts
 - Low AFR cycle
 - The “No Plan” plan can result in additional \$66,000/month in estate taxes¹!
- **Consolidate Ownership**
 - Buy out non-optimal shareholders
 - 3.8% Medicare surcharge
 - Low capital gains

¹ For illustrative purposes only.

Strategic Opportunities: Sale to Third Party

- **Wear Hat of Buyer**
 - Curb appeal
 - Assess drivers
 - Talented and likeable managers
 - Audited financials
- **State of the Market**
 - Frothy?
 - “Private equity firms now have more than \$1 trillion of available capital. Expect more deals at higher prices.” – Fortune.com

Strategic Opportunities: Sale to Third Party

- **What's It Worth?**

- Strategic vs. financial buyers
- EBITDA vs. adjusted EBIDTA
- Multiplier
 - Industry specific
 - Growth prospects
 - Firm size
 - Established financial history
 - Earnings stability/volatility
 - Top talent in place
 - Owner participation
 - Concentrations
 - Unique vs generic product/service

- **Strategic Positioning**

- “It’s not what you get – it’s what you keep
- Long-term capital gain rate still low (20%).
- Core Assets – Real Estate – Cash

Strategic Opportunities: The Rest of the Story

- **Other Options**

- Internal management buy-out
- ESOP
- IPO

- **Polishing the Apple**

- Knowledge is power!
- Manage as a dual track process
 - Plan A as chosen with
 - Back-up Plan B
- Analyze value, cash flow, liquidity and risk

Changing Paradigms

Valuation Planning

The Old Paradigm

“I know what my business is worth based on the offers I get.”

Valuation Planning

The Old Paradigm

“I know what my business is worth based on the offers I get.”

The New Paradigm

“Valuation is an art . . . and a science.”

- Strategic \$30 million
 - Financial \$25 million
 - Estate \$18 million
-
- Purpose driven
 - Preserve confidentiality

Family Business vs. Family Wealth

The Old Paradigm

“My grandparents started this business and I am keeping it for my kids and grandkids.”

Family Business vs. Family Wealth

The Old Paradigm

“My grandparents started this business and I am keeping it for my kids and grandkids.”

The New Paradigm

“The business world is more complicated than it used to be. My family wants to do something else.”

- Control of family wealth is more critical than control of family business
- Opportunity cost. Would you buy your business at the same price?

Static Documents vs. Dynamic Objectives

The Old Paradigm

“I own my business 100%, so no need for employment agreement, incentive plan or shareholder’s agreement.”

Static Documents vs. Dynamic Objectives

The Old Paradigm

“I own my business 100%, so no need for employment agreement, incentive plan or shareholder’s agreement.”

The New Paradigm

“I have to strategically position the business and wealth. Protect the business, my family and employees.”

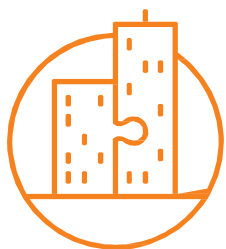
- Keep
 - Death, disability and retirement
 - Ownership and management continuity
 - Establish rules of entry and family business governance
 - Market rate vs. birthright
- Transition to third party
 - Position/protect A-team players
 - Conflicting documents

Strategic Positioning – Next Steps

- Put Team together
 - AEP® is collaboration designation!
- Understand your options
- Learn where business and family goals are at cross-purpose—and align
- Establish legacy for future generations
- Plan and fund away the estate tax obligation

Freedom of Choice

More dollars to



Your Businesses



Your Family



Your Community



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