

# BUSINESS SUCCESSION PLANNING FOR FAMILY BUSINESSES AND BUSINESS FAMILIES

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# Lessons learned over 15 years

Tell the family stories

    Histories

    Values

Family Councils

Family Philanthropy

## Two tracks

- Family
- Business

## Family Values

- Unconditional acceptance of members
- Sharing the fortune
- Ownership succession

## Business values

- Competition
- Reward merit
- Innovation
- Management succession

# Generational change in family business

# The last generation

Pervasive informality

Failure to use common management tools

Limited use of outside directors

# Today's generation

Family businesses are professionalizing

Recruitment and retention

Family involvement—60% own interests but are not employed

Mission

Values

Governance—64% have outsiders on board

Succession planning

# 2021 Survey

## ESG issues – prioritize community over profits

- Increase employee engagement and enhance customer relationship
- 45% see opportunity to lead the way in sustainable business practices
- 23% have developed and communicated sustainability strategy
- Only one-third believe they should fight climate change

## Workers seek more digital skills, inclusivity, and flexibility

- Employee experience is as important as pay
- Digital upskilling a must
- Competition for talent is intense

## Governance

- One-third have robust, documented, and communicated succession plan
- 9% revised plan in response to pandemic
- 67% already have employed next-gen family members
- Most G-1 leaders expect next-gen family members to become majority shareholders within 5 years

## Leaders must engage family members and company managers in dialog that addresses

- digitization
- diversification
- upskilling
- ESG initiatives
- family succession plans

# The family business in 2021

It is alive and well

The inverted pyramid



remains

# BUSINESS SUCCESSION PLANNING

## WHY FEW MAKE IT TO THE THIRD GENERATION

- Estate tax
- Liquidity event
- Family disharmony
- Ineptitude or lack of commitment
- No formal succession planning
- The leader stays too long
- THE ECONOMY
- BAD LUCK

OWNERSHIP SUCCESSION  
V.  
MANAGEMENT SUCCESSION

“Being the owner of a plane doesn’t mean you have the right to fly it, and being the pilot doesn’t mean you can decide which routes to fly.”

– Amy Braden

# ONE MAN'S EXPERIENCE

- Failure to prepare succeeding generations
- Narrow focus of advisors
- Large teams of advisors or long retreats don't work
- Protect the viability of the business
- Address the soft issues that affect the family
  - Emotional and relational
  - Commit to the process
  - Be inclusive
  - Be patient
- Get on the ground. Do the job.
- Engage a family business consultant—if necessary.

- Appreciate risk aversion
- Be mindful of different transitions – Doud
  - The founder or current leader
  - The family
  - The business
  - The management
  - The ownership
  - The estate

- Understand and avoid Hughes' three-stage process of business development: periods of creativity, stasis, and decay.
  - Preserve family's human and intellectual capital
  - Remember that each generation must create wealth
  - Be disciplined and patient to pursue the process
  - Appreciate and manage liabilities. Avoid trying to preserve the status quo
  - Understand that the fundamental issues of wealth preservation are qualitative, not quantitative
  - Tell the family stories that relate to its history and values

- Organize a family council
  - Multi-generational
  - Creates own rules
  - Adopt a statement of values
  - Meet regularly
  - Educate and inform
  - Provide linkage and voice

# JPMORGAN'S EIGHT PROACTIVE PRACTICES OF SUCCESSFUL FAMILIES

1. Articulate a clear vision
  - a. Mission
  - b. Values
2. Cultivate entrepreneurial strengths
  - a. Venture capital fund
  - b. Provide seed capital
3. Plan ahead to reduce risk and act on opportunities
  - a. Trust and estate planning
  - b. Long-term investing
4. Build unifying structures that connect family, assets, and community
  - a. Family office
  - b. Investment funds
  - c. Philanthropy

5. Clarify roles and responsibilities
  - a. Family member
  - b. Owner
  - c. Manager
6. Communicate
  - a. Family reunions
  - b. Video conferences
  - c. Websites
7. Help individuals develop competencies
  - a. Work experience
  - b. Stock picking games
  - c. Next generation programs
8. Foster independence and provide exit options

# CONCLUDING THOUGHTS

- Get beyond the numbers and tax considerations and the documents
- Remember that the client and his or her family haven't done this before
- Remember that what worked for the last generation may not work for the next
- Remember that equal is not fair and fair is not equal
- Challenge the next generation
- Provide exit opportunities
- Avoid surprises – communicate the plan to the family
- Be the counselor, the trusted advisor

# THE TRANSFER TAX PART

# EXTENDING THE TIME FOR PAYMENT

- §6161
  - Discretionary based on reasonable cause
- §6166
  - Effective
  - Qualification standards

# BORROWING FROM THIRD PARTIES

- Rulings – Acceleration = Deduct as you pay
  - Rev. Rul. 80-250
  - Rev. Rul. 84-75
- Cases
  - Graegin
  - Keller
  - Murphy
  - No second-guessing fiduciary
- Conclusions
  - Caveat borrowing from the entity to be valued
- Disadvantages – No income tax deduction
- Advantages
  - Interest deduction without discount on estate tax return
  - Opportunity for positive leverage
  - Time values

# VRDNs

- What is it?
  - Floating rate bond issue
  - Credit enhanced by bank letter of credit
  - Buyer has put
  - Weekly re-pricing
  - Low interest
- Parties
  - Borrower
  - Letter of credit provider
  - Trustee for noteholders
  - Placement/remarketing agent
- How it works
  - Terms negotiated by borrower and letter of credit provider
  - Purchasers rely on balance sheet of letter of credit provider
  - Placement/remarketing agent prices, places, and remarkets
  - No registration requirements if bank provides letter of credit

# FIXING THE RATE

- The interest rate swap
- Per contract, borrower pays fixed rate and counterparty pays floating rate
- Historical equivalence between swap rate and VRDN rate

# BORROWING COSTS

- Issuance fees
  - Placement fee
  - Counsel fees for letter of credit provider, bond counsel, and trustee's counsel
  - Trustee's origination fee
  - Rating agency fee
- Annual fees
  - Letter of credit fee
  - Remarketing fee
  - Trust administration fee

# FINANCIAL COVENANTS

- No additional indebtedness
- No liens will attach
- Monthly financial statements
- Minimum level of liquid assets
- No distribution except to pay debt service and taxes

# AVOIDING THE TAX

## LEAVE IT ALL TO CHARITY

- Outright bequest
- Bequest to a CLT

# PENALTY TAXES

- Excess business holdings
  - 20% of voting interests minus interests of disqualified persons
  - 5-year disposal period in cases of gifts and bequests
- Jeopardizing investments
  - Ordinary business care prudence
  - Exception for investments gratuitously transferred to private foundation
  - Change in form of investment = new investment
- Self dealing

# SELF-DEALING RULES

- Self-dealing
  - Direct or indirect transaction between private foundation and “disqualified person”
  - Disqualified person
    - Substantial contributor
    - Foundation manager
    - More than 20% owner of a substantial contributor
    - Family member of any of the above
    - Entity or trust over 35% owned by any of the above
- Exceptions from self-dealing rules for estates or revocable trusts
  - Executor has power of sale or property is subject to option
  - Probate court approves transaction
  - Transaction occurs before estate is considered terminated
  - Estate receives at least fair market value of the property
  - Transaction does not leave foundation with less liquidity or is required by binding option
- The example in the regulations
- Favorable rulings and commentary

# THE TRANSACTION

- The will
  - Stock or limited partnership interest
    - Married person
      - Stock or partnership interest to QTIP trust
      - At death of survivor, interest passes to CLAT
      - Stock or limited partnership interest is subject to children's option to purchase at fair market value
      - If option is exercised, consideration is note and collateral is stock or limited partnership interest
        - Terms of note
          - 20 years
          - Interest at rate sufficient to pay annuity plus CLAT administrative expense
      - Widow or widower – same as above without QTIP
- Refinements
  - Executor selects among CLATs of different duration
  - Graduated annuity

# THE TRANSACTION (cont'd)

- Advantages

- Children acquire stock or limited partnership interest immediately
- Possible discounted purchase price
- No cash required
- Interest only is payable for term
- Principal is never paid
- Children can control the private foundation which receives the CLAT annuity
- The owner is not tied to a structure

- Disadvantages

- Long-term cash flow requirement
- No GST planning possible unless...
- Ages of children when CLAT term expires
- Difficulty in funding annuity after a sale

# SECTION 163(j)

Effective for tax years beginning after 2017

- Special rules for 2018-2021

Limits deduction for business interest to sum of

- business interest income
- 30% of adjusted taxable income (“ATI”) (“the 30% Limitation”), and
- floor plan financing interest

## Small business exemption

- gross receipts less than or equal to \$25,000,000 for 3 prior years

ATI means tentative taxable income computed without regard to

- the §163(j) limitation
- any disallowed business expense carryforwards
- any income, gain, deduction, or loss not properly allocated to a trade or business
- any business interest or business interest income
- the amount of any net operating loss deduction
- the amount of a deduction allowed under §199A
- the amount of any capital loss carryback or carryforward

“Trade or business” does not include excepted trades or businesses (“excepted trades or businesses”)

- the trade or business of performing services as an employee
- any electing real property trade or business
- any electing financing business
- regulated public utilities businesses

Disallowed business interest is treated as business interest paid or accrued in the succeeding taxable year

## Special rules for partnerships

- rules are applied at partnership level
  - any deduction for business interest is taken into account in determining non-separately stated income or loss of partnership
  - any business interest not allowed as a deduction to the partnership (“excess business interest”) is not treated as paid or accrued by the partnership in the succeeding taxable year but rather is allocated to each partner
- such excess business interest is treated as paid or accrued by the partner in the next succeeding taxable year in which the partner is allocated excess taxable income (“ETI”) from the partnership but only to the extent of such ETI.
- any remaining excess business interest is treated as paid or accrued by the partner in succeeding taxable years
- The ATI of each partner
  - Is determined without regard to the partner’s distributive share of any item of income, gain, deduction, or loss of the partnership, and
  - Is increased by the partner’s distributive share of the partnership’s ETI.

## ETI

- the amount which bears the same ratio to the partnership's ATI as
- the excess of the 30% Limitation over
- the amount by which the business interest of the partnership exceeds its business interest income
- bears to the 30% Limitation

Example: A and B are equal partners in pro rata partnership X. The partnership has ATI of \$100, business interest of \$40, and business income of \$20. X's ETI is  $\$100 \times .30 = \$30 - (\$40 - \$20) = \$10 / \$30 \times \$100 = \$33$ . \$16.50 of ETI is allocated to each of A and B.

- Basis adjustments
  - The adjusted basis of a partner in his partnership interest is reduced by the amount of excess business interest allocated to the partner
  - If a partner disposes of a partnership interest, his adjusted basis is increased immediately before the disposition by the excess of the amount of the basis reduction over the portion of the excess business interest of the partner which has been treated as paid or accrued by the partner
  - This rule applies to transfers of a partnership interest (including by death) in a transaction in which gain is not recognized in whole or in part

“Rules similar to the rules of subparagraphs (A) and (C) shall apply with respect to any S corporation and its shareholders.”

- Section 163(j) applies to business interest at the S corporation level
- Unlike partnerships, disallowed business interest is carried forward at the corporate level and treated as business interest paid or accrued in the succeeding year
- Like partners of partnerships, the shareholder of an S corporation does not include his distributive share of the S corporation’s income, gain, deduction or loss for purposes of computing the shareholder’s ATI
- The S corporation allocates its ETI to shareholders in accordance with their pro rata interests in the S corporation
- The shareholders, in turn, include that ETI in their ATI for purposes of computing their §163(j) limitations
- If a shareholder disposes of stock in an S corporation which owns only assets used in non-excepted trades or businesses, any gain or loss is included in the shareholder’s ATI

## Issues for those who finance the acquisition of S corporation stock with debt

### Example:

A buys all of the stock of S corporation X and plans to run it as CEO (materially participating). The purchase price is \$10,000,000 financed 100% with a 20-year 6% note which requires the payment of interest only with principal due at the end of the term. A's compensation from X is \$500,000 after which X has ATI of \$1,000,000. It pays business interest of \$200,000 per year and it has no business interest income. X's interest is fully deductible ( $\$1,000,000 \times .3 = \$300,000$  which is greater than \$200,000). X's ETI is computed as follows:  $\$1,000,000 \times .3 = \$300,000 - \$200,000 = \$100,000 / \$300,000 \times \$1,000,000 = \$333,333$ . That becomes A's ATI because he has no income other than his salary the source of which is an excepted trade or business. Hence, although he reports S corporation income of \$1,000,000 and pays interest of \$600,000, he can deduct only \$100,000 ( $\$333,333 \times .3$ ). Unused ETI cannot be carried forward.