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Realities of family business succession

"If you fail to plan, you are planning to fail!"
—*Ben Franklin*

Family businesses are the backbone of the U.S. economy. 28 million small businesses account for 54% of all U.S. sales and 55% of all sales.[1] Up to 35% of Fortune 500 businesses are family controlled.[2] According to Harvard Business School, just over half of all publicly listed companies in the U.S. are family owned. Family businesses employ over 50% of the employees in the U.S.

Dramatic demographic changes are radically impacting family businesses—chief among them being the looming transition of ownership and control to the next generation. On average, over 10,000 Baby Boomers a day retire, many of whom are entrepreneurs with family businesses. According to a PricewaterhouseCoopers 2017 Survey of Family Businesses:[3] 52% of owners who plan to transfer their business between 2017 and 2022 intend to keep the business within the owner's family; 30% intend to sell their business to non-family members; and 18% do not know what they will do.

Although succession is looming, there is a profound lack of advance planning. A February 10, 2011, *New York Times* article entitled "*Are Baby Boomers Ready to Exit Their Businesses?*" reported that 96% of Baby Boomer business owners thought that a business succession plan was an important idea, but 87% had no written exit plan. Part of this lack of planning may be explained by a 2010 Gallup Poll, which noted that 47% of small business owners never intend to retire unless forced to by health issues. Unfortunately, the result often will be less than capable family members running or trying to dispose of the business after the entrepreneur dies.

Although the underlying reasons vary widely, few family businesses survive multiple generations:[4]

Percent of family businesses held by the second generation:	30%
Percent of family businesses held by the third generation:	12%
Percent of family businesses held by the fourth generation:	3%

Why such a significant reduction in family business transfers? For those business successions that fail, the reasons for the failure are not what many would expect:[5]

- 60% are due to communication and trust problems within the family.
- 25% are due to the failure to train and prepare the next generation on running the business.
- 15% are due to other issues, such as taxes, financial difficulties and poor advice.

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A massive passage of business interests will occur in the next several decades. The question is: How do we as estate planners adapt to it? There is a great quote by Eric Hoffer: "*In times of change, learners inherit the earth, while the learned find themselves beautifully equipped to deal with a world that no longer exists*." This changing environment will bring tremendous opportunities for the creative and the prepared. It also will bring lots of work for the clients who passed without having a plan for that inevitable.

When considering the passage of a family business, there are a number of important realities that need to be understood.

Incapacity May Occur

Baby Boomers and their parents are moving unalterably toward their own mortality. The Census Bureau has reported that Americans 85 and older are the fastest growing demographic group. According to a 2017 report from the Alzheimer's Association,[6] women at age 65 have a 21.1% lifetime risk of having Alzheimer's, while men have 11.6%. Part of the discrepancy may be due to the fact that men do not live as long as women. Moreover, other forms of diminished capacity[7] increase the likelihood of this potential problem.

The recent conflicts over Sumner Redstone's ownership and control of Viacom and CBS should be an advance warning to any business owner of the need to plan for the possibility of incapacity. Sumner Redstone is one of the wealthiest people in America, with an estate estimated to be over $42 billion.[8] On September 3, 2015, Mr. Redstone named his longtime companion, Manuela Herzer, as his health care decision maker under a health care power of attorney.[9] In October 2015 he eliminated her from his Will (which would have passed $70 million to her) and his health care power of attorney (replacing her with his daughter, Shari Redstone). In reaction, Ms. Herzer claimed that he was not competent and asked a Los Angeles court to place her in charge of his health care decisions. If successful, her health care challenge probably would have led to a challenge of the Will changes. Ms. Herzer's case was dismissed, with the judge ruling that Ms. Herzer had not proved her case, but without the judge ruling that Redstone was competent.

But the fight over the control of Mr. Redstone's assets was not remotely over. On May 20, 2016, the CEO of Viacom and another Viacom Board Member were removed as two of the seven Trustees of two Trusts that owned the controlling interest in Viacom and CBS. The removed Trustees' verbal response was: "*These steps are invalid and illegal. As court proceedings and other facts have demonstrated, Sumner Redstone now lacks the capacity to have taken these steps*."[10] On May 23, 2016, the two removed Trustees filed suit against Shari Redstone, arguing that she was manipulating her father and exercising undue influence on his decisions. In August 2016 a settlement was announced between the Trustee/Directors and Sumner Redstone and Shari Redstone.

Sumner Redstone's granddaughter said that her aunt, Shari Redstone, and Shari's three adult children had "*succeeded in reversing decades of my grandfather's careful estate planning and are poised to seize control of Viacom and CBS*."[11]

Americans are living longer, but often with diminished capacity. Family business owners need to plan thoughtfully for their incapacity as much as they plan for the passage of their estate. Many clients fail to understand that diminished capacity does not necessarily limit the ability of a client to modify his or her estate plan. For example, an old case captures how the courts deal with this issue: ""*[a] man may believe himself to be the supreme ruler of the universe and nevertheless make a perfectly sensible disposition of his property, and the courts will sustain it when it appears that his mania did not dictate its provisions*." [12]

Death *Will* Occur

We will all die. In 2015, 2.7 million U.S. residents died[13] (up from 1.7 million in 1960). The number of dying U.S. residents will increase as the Baby Boomer bubble begins to burst. A 2008 Census Bureau report projected the following future deaths:

Year	Total Deaths
2020	2,867,000
2030	3,316,000
2040	3,881,000
2050	4,249,000

However, many business owners appear to have unconsciously adopted Paul Simon's perspective from his 1965 song *Flowers Never Bend with the Rainfall:* "*So I'll continue to continue to pretend that my life will never end.*" Death will happen to all of us—and most of us will suffer at least one period of incapacity before passing. A 1996 Merrill Lynch study reported that those over age 65 are twice as likely to avoid estate planning than those under age 65. According to an AARP study, only 17% of Americans over age 50 have a current will and durable power of attorney.

Planning for death should not be fundamentally about avoiding taxes and protecting assets. Instead, the primary focus should begin with the goal of "protecting and preserving the family" and minimizing sources of conflict that may develop when the patriarch or matriarch of the family passes away. The purpose of estate planning is being reevaluated by many clients and their advisors. The pivotal reality is that estate planning needs to focus first on how clients deal with their inevitable death and potential incapacity. It is about clients trying to make the right decisions about their own mortality, the consequences of their passing, and how to leave a positive **LEGACY** for their heirs.

This perspective starts with understanding that estate planning does not start with **THINGS** or the taxes imposed upon them. It starts with **PEOPLE**: Who clients were and are and who their families are and might become. In the last two decades, the author has observed a significant reorientation of both clients and advisors from believing that protection and preservation of family assets (e.g., minimizing transfer taxes and asset protection) are the most important goals of estate planning. Increasingly, clients and their advisors recognize this is a misplaced emphasis that focuses both the client and the planner on assets rather than family and on structure and technique over family goals. When *"protecting and preserving the family"* becomes the beginning point of planning, clients first focus on how to leave a positive impact for their family. Both the client and the planner may be forced to deal with difficult family issues (for example, treating the descendants as individuals with their own personalities and problems, not as equals), which both the client and the planner might have preferred to ignore—to the ultimate detriment of the client's family.

It is not that tax and asset issues are unimportant. They just pale in significance when compared to family issues. Instead of wrapping the estate plan around the tax issues, clients are increasingly starting with the family issues and then wrapping the tax issues around the family goals and needs.

Many clients (though clearly not all of them) increasingly have begun to address the issue of "*how much is too much*"—or as Warren Buffett said in a 1986 article in *Fortune* magazine: *"The perfect inheritance is enough money so that they feel they could do anything, but not so much that they could do nothing."* As a result, affluent clients are increasing their charitable gifts and bequests as their assets grow. In some cases, a portion of the business will pass to designated charities.

Inherent within the issue of leaving a legacy is the desire to minimize family conflicts. According to the Wealth Counsel 6th Annual Industry Trends Survey, the top motivation for doing estate planning was to avoid chaos and conflict among the client's heirs. Many clients have an abiding desire to establish structures that minimize the potential points of conflict and provide a mechanism to resolve future family conflicts. Clients want to dispose of assets in a manner designed to minimize family conflict—leaving a legacy of relationships rather than a legacy of conflict. This is a growing part of the discussion with clients and a part of their planning documents.

As noted at the beginning of this article, it is not taxes that destroy most family businesses, it's the lack of communication and trust problems within the family and the conflicts that ensue from these deficiencies.

Taxes Are Not Going Away

The permanent transfer tax exemption levels enacted by the American Taxpayer Relief Act of 2012 ("ATRA") on January 2, 2013, have reduced substantially the number of U.S. residents who will be subject to a federal transfer tax. These changes reduce the transfer tax costs for business owners transferring their businesses. But ATRA also increased the top federal income tax rate to 39.6%. Given the various taxes on small business owners, their top combined state and federal income tax rate is easily approaching or exceeding 50%.

One result of ATRA is that federal income tax avoidance will largely trump federal estate tax avoidance for the majority of taxpayers. The income tax has replaced the estate tax as the most significant confiscation tax of moderately wealthy business owners.

A 2013 Congressional report[14] noted that less than 0.2% of all estates will be taxable. However, for those that remain subject to a federal estate tax, the IRS review of the estate has grown significantly. The IRS reported that for the fiscal year ending September 30, 2012, the effective audit rate for estates over $10 million was 116%. Overall, 30% of all estate tax returns were audited.[15]

The Trump administration has discussed the possibility of lowering the federal income tax rate on small businesses to 15% to 25%, but the impact on the deficit may reduce this rate reduction. There is also a discussion of repealing the federal estate tax.[16] However, it is not clear if Congress will pass proposed tax changes, and it increasingly appears that any changes may not occur until sometime in 2018, when passage will be complicated by the 2018 Congressional midterm elections.

Virtually every intrafamily transaction that a business owner enters into has income tax implications that need to be addressed. For example:

• Many business owners consider selling their business to their heirs. But this can be a poor tax decision. In order to pay any deferred payment to the departing business owner, the heir generally has to pay income tax (and sometimes payroll taxes) on income earned by the business. The payments then made to the former owner are again subject to income taxes. There are more creative ways to pass a business interest without paying substantial income taxes on the sale.

• Gifting S corporation stock to a family Dynasty Trust can terminate the S election for all shareholders if the trust does not contain certain required provisions.

• Transferring a flow-through business interest (e.g., an LLC, partnership, or S corporation) to a family trust must take into account how the cash flow will fund the allocated income tax costs of the trust or its beneficiaries (i.e., just because taxable income is allocated, does not mean a comparable distribution is made from the business).

• In 2017 if an estate or trust has more than $12,500 in undistributed ordinary taxable income, it will be subject to a federal tax rate of 39.6%, plus state income taxes, which can drive the total tax rate to over 50%.

Even though there has been a significant reduction in the federal estate tax, states may increase their estate and inheritance taxes to fund their imminent budgetary shortfalls. Dead people are an easy source of revenue.

There Is No Equity Value to a Family Business

When an entrepreneur wants to pass his or her business to family members, there is no true equity value to the business. Because the equity will not be reduced to cash (i.e., by a sale of the business), it provides no current benefit to the business owner. In fact, **the equity value of the business is a liability waiting to happen** because of the potential state and federal transfer tax and income tax liabilities on the passage of the business.

When the issue is addressed properly, the owner is interested in control of the business and the income and benefits that are derived from that control. Using readily available planning approaches (e.g., deferred compensation, voting rights, partnerships, and trusts), the income and control of the business can be separated from equity, and the equity can be passed at a reduced tax cost to family members using various techniques (e.g., minority and lack-of-marketability adjustments).

The retention of the equity value of the business may create a transfer tax liability that could have been reduced or even eliminated. By retaining ownership, the entrepreneur loses the ability not only to discount the present value of the business but also causes the family to pay estate taxes on the appreciation in the business. For example, assume that in 2017 a married taxpayer has a $20 million company and transfers all of the business to three separate family trusts for his three children and their descendants. The client dies 15 years later. Such a gift has a number of benefits:

• If the minority interest that was transferred to each trust were discounted at 45% and the donor's spouse agreed to gift splitting, the couple's combined gift tax unified credit would cover the entire gift (i.e., $20 million discounted at 45% is worth $11 million—less than just over the couple's combined gift exemptions).

• Because of valuation adjustments, even if the business did not grow, the immediate estate tax savings would be as much as $3.6 million (i.e., the $9 million valuation adjustment times a 40% estate tax rate).

• But what if the business grew at a 10% annual rate until the parents died 15 years later? At the end of 15 years, the prior transfer will have moved $84 million out of the donor's estate, saving the family an additional $25.6 million in estate taxes (i.e., $64 million in appreciation at a 40% estate tax rate in 15 years).

• Trustees selected by the entrepreneur may control the gifted business interest and decide how trust distributions will be made to family members. With proper drafting, the business owner and/or heirs may retain the ability to remove the trustees, without the trust assets being included in the taxable estate.

Essentially, state and federal transfer taxes are a voluntary confiscation tax. With proper planning the confiscation can be minimized or eliminated. The key is recognizing that equity is not the same element as control—and control allows the owner to benefit from the income of the business. The thoughtful business owner recognizes this difference and realizes that transferring current equity (and its future appreciation) can reduce the future tax burden on the business, without adversely impacting the owner's income or control. Contrary to the owner's intent, the emotional retention of all of the equity ownership actually can destroy the business.

The Inevitable Conflict

Many business owners intend to pass their businesses to one or more designated family members who will run the business after the entrepreneur's death or retirement. However, because the business is often the largest single asset of the estate, the owner often passes part of the business ownership to other family members who are not involved in the business.

During the owner's lifetime, the owner may have been able to maintain peace in the family and serve as the "benevolent dictator" of the family business. Unfortunately, this powerful role disappears with the entrepreneur's death or incapacity. Sibling rivalry, in-law problems, and other issues begin to come forward, particularly between those who operate the business and those who are outside the business.

Almost inevitably, the outsiders feel that the compensation and perks provided to the insiders are "excessive." Outsiders question the business decisions (e.g., capital expenditures, hiring and firing of employees, expansion plans) of the insiders even when they know little about the business' needs, operations, or competition. Outsiders often believe that the income paid to them should match the compensation paid to the insiders.

Meanwhile, the insiders (who often feel that they are working too hard) resent that their sweat is increasing the equity value of the outside family members who are continually asking for more and more income to which they are "not justly entitled." The insiders often fail to see that the outsiders have a right to a return on their "investment" in the business. Many family businesses have paid huge legal fees because of these conflicts and/or have been forced to sell the business to alleviate the problem.

This conflict is inevitable as each family member attempts to direct his or her own financial destiny and feels increasingly unable to do so because of the common business ownership with other family members. This is not a matter of "good" and "bad" family members. It is a matter of increasingly different life goals—a normal part of life.

The solution lies in setting up a structure in the estate plan that ensures that those in the business own and control as much of the business as possible, while giving outsiders other assets so that they can effectively control their own financial destiny. Life insurance is often a necessary element of this "equalization planning." This planning process is best done during the business owner's life so that the entrepreneur can dictate the terms to family members. Often the entrepreneur will recognize the contribution to the business of those who have had long-term involvement by passing a greater part of the business to them.

Heirs May Increase Their Own Burdens

A son works in the family business. Over 20 or 30 years, the son helps grow the value of the father's business—only to share it with his siblings and a not-so-appreciative stepmother. By not addressing the issue before the father's death, the son will have increased his own burden.

Many clients make the mistake of growing the family business in the wrong estate. For example, a parent has a very successful business and is considering branching off into new areas. The client has an estate that will be taxable in a 40% transfer tax bracket. Have the parent help the adult child create this new business opportunity and have ownership of the entity solely in the name of the child or in a Dynasty Trust. The older generation should not control or have the economic risk for the new business opportunity. Combining the two business entities together may be possible at some time in the future and (with proper valuation) give the heirs a larger part of the total business.

Arguably, the following facts could strengthen the client's case that a taxable transfer of a business opportunity passed to the next generation (i.e., court or IRS determinations will be fact-specific):

- No assets or contracts are transferred gratuitously by the new entity.
- The old business continues to operate.
- The owner of the existing business does not work in any capacity for the new business when it is created.
- The economic risk of the venture should rest solely on the new business owners. The parent and the old business should not directly or indirectly guarantee the obligations of the new owners and their business.
- Minimize transactions between the two businesses.
- The children worked in the business for a period of time and by doing so acquired their own business goodwill through the relationships that they created or broadened.
- The new business owners are not subject to any non-compete, non-solicitation, confidentiality, or trade secrets limitations.
- A significantly different name is used for the new business.

Even if a business owner is unwilling to address the value of the child's long-term contribution, children in the business should address the issue.

Divorces and Remarriages Will Happen

Many family businesses started off as a partnership of like-minded people. It is the author's impression that divorces in small businesses most often occur because the business does too poorly or is too successful. Small business owners need to draft business prenuptial agreements (i.e., buy-sell agreements) at the beginning of their business marriages. When the business is owned by related parties, the need is even more acute because, in many cases, unrelated familial issues complicate the business interactions. The documents should deal definitively with how the business marriage will be terminated with the least amount of damage to the business and its owners. For example:

- If the remaining owner is buying out the interest of the departing owner based upon a "going-concern-value" of the business, the remaining owner needs to make sure that the agreement limits the ability of the departing owner to compete with the business or solicit its customers from a building across the street.
- Most small business owners are forced to guarantee the debts of the business. The buy-sell agreement should deal with how those guarantees are removed and/or indemnified.
- Do you really want the spouse of your deceased co-owner co-owning the business with you? Buy-sell agreements should be drafted to allow the family to purchase ownership interests that pass to non-blood family members at divorce or death.

But it's not just business divorces that need to be dealt with. Almost 50% of all marriages end in divorce. According to a 2012 *Wall Street Journal* article,[17] the divorce rate for Baby Boomers is skyrocketing, even while it is diminishing for other demographic groups. According to the article, "*Among divorces by people ages 40-69, women reported seeking the split 66% of the time*." If divorce is such a prevalent issue, why do we so often ignore the possibility in our planning?

Every entrepreneur's estate plan should address the possibility that the entrepreneur or an heir will face a future divorce. Although the discussion may be awkward for the client and advisors, it is an unpleasant prospect that should be addressed directly. Clients should consider inheritance vehicles that restrict the ability of a divorcing spouse to obtain family assets.

Whether single by widowerhood or divorce, men tend to remarry more quickly than women. According to a 1996 University of California study,[18] 61% of widowers are engaged in a new romantic relationship within 25 months of their wife's death, and only 19% of the widows have a new relationship. According to an AARP report,[19] at age 70 men are twice as likely to have a current or recent sexual partner as women of the same age. Dad's marriage to a woman 20 years his junior has created heartburn for many children who have been anticipating a larger and quicker inheritance.

Remarriage of a business owner creates significant new rights and powers in the new spouse that can upend the expected passage of the family business. For example:

- Every state except Georgia permits a spousal elective share to a surviving spouse or a community property right in a spouse upon the death of the other spouse. A "spousal elective share"[20] refers to a legal claim that a surviving spouse has against a portion of the assets of a deceased spouse, even if the deceased spouse disinherited the survivor.
- There are at least three ways that a surviving spouse can obtain an intestate share of a deceased spouse's estate. First, if a married client dies without a Will (or similar dispositive documents), then the surviving spouse is entitled to an intestate share of the estate. Second, in many states, if the decedent's Will existed before a marriage and was not made in contemplation of the marriage, the new spouse is entitled to an intestate share of the estate. For example, Georgia provides:[21] *If the will was made prior to [a marriage]…., and does not contain a provision in contemplation of such an event, the subsequent spouse …. shall receive the share of the estate he or she would have received if the testator had died intestate."* Third, even if the decedent spouse executed a new Will, there is a least one other route by which a surviving spouse could inherit. If all of the named heirs should predecease the decedent, the surviving spouse might have a right to inherit as a surviving intestate heir—with a priority of intestate inheritance in front of more remote family members.
- In the absence of Medical Directives and/or Durable General Powers of Attorney, most states provide that the current spouse has the highest priority to serve as Guardian/Custodian over the assets and/or person of an incapacitated spouse. In a number of states, appointment of a guardian (e.g., the current spouse) revokes or limits the agent holding a General Power of Attorney (e.g., Florida, Texas, Virginia, and Washington).
- In the event of an intestate estate or the failure of all named Personal Representatives to serve, the surviving spouse generally has a priority right to be the Executor/Personal Representative of the deceased spouse's estate, even if there are children from a prior relationship.

Clients who address these realities will reduce future heartaches and avoid the potential destruction of the family business by taxes and family conflicts.

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Endnotes

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20 The right is also referred to as "spousal share," "widow's share," "statutory share," "election against the will," and "forced share."

21 O.C.G.A. § 53-4-48(c) (2014).