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PROTECTING THE BUSINESS

Business Succession Planning as Strategy

PROFESSIONAL OPINION

Karen Schaefer
Partner
Lacy Katzen LLP

Business succession planning, as part of your business strategy, sets the vision for your end game. While it may be enticing to avoid succession planning given the uncertainty in the current tax and regulatory environments, this may be the best time to focus on your business succession plan.

The business succession choices are straightforward: Focusing on the business, the competition and the industry within which you operate, are you better off to position the company for sale or for transition to a management team within the company? Or are you better off operating the business to generate income? The choice will inform you as to what you need to do to achieve your goal. If the ultimate goal is a sale, what must you have in place to maximize the value on the sale? How is your business valued? Do you need to increase EBITDA, sales revenue, recurring revenue? Do you have intellectual property (trademarks, patents, copyrights) that need to be protected? Have you institutionalized management processes so the business value is not dependent on you or key individuals?

If the ultimate goal is to transition the business to family or a management team, what are the capacity and talent deficits and what must you do to build that team? What incentives and agreements (incentive compensation, owner buy-sell agreements) do you need in place to build the business until transition can take place?

If a sale would generate after-tax net proceeds that is less than the income produced by operating the business for a certain number of years, and if you plan to build a management team, an ESOP may be a good choice to eliminate the tax bite. (You exchange 30% or more of your equity in the business for domestic securities and defer income tax on the sale or eliminate tax completely.)

Are you in a holding pattern? The earlier you are in the process and the more time you have to raise your children and develop the successor management team, the more flexible the planning must be. The business agreements and estate plan should not lock in choices that you will regret.

The key to successful business succession planning is to integrate the process with your personal estate plan. Planning for both flushes out critical facts relating to valuation, assessment of management and talent, finances, income, family relationships and family needs, and brings key management and family members (spouse and children) into the process. From the estate planning perspective, we need to differentiate business succession planning from crisis planning. Crisis planning involves addressing events such as death or disability that could occur prior to finalizing the business transition, and which otherwise can wreak havoc with the business and the family if not anticipated or planned for in the business agreements and estate planning documents. If death occurs, one solution is life insurance owned by an irrevocable life insurance trust (ILIT) that will be protected from estate tax and claims of creditors, and yet be available for family support and cash flow for the business. Another crisis solution is to decide on the people to serve as your executors, trustees and agents under a power of attorney. You need to create a team. It may be a combination of family and trusted people with business acumen to make decisions regarding the sale or transition, and the operation of the business until the sale or transition can occur.

Don't let the current tax and regulatory uncertainty derail you from engaging in the business succession and estate planning process. Consider that there are few occasions when you can be absolutely certain about anything, and, if that is true, your goal is not to eliminate uncertainty, but rather to be clear in the face of uncertainty.

Having said that, understanding the uncertainty informs us on how best to build flexibility into our plans. The current Republican agenda includes repeal of the estate tax, but interestingly, not the gift tax. It also includes significant reduction to the income tax. Note that the gift tax acts as a backstop to the income tax, preventing taxpayers from shifting income-producing assets to other family members in lower income tax brackets.

The estate tax possibilities include: (1) retain the estate tax with exemptions ($10,980,000 in 2017 indexed for inflation); (2) outright repeal of the estate tax; (3) phased-in repeal with a sunset provision that springs the estate tax back into place at the end of a certain period; (4) repeal, but later reenactment, when Congress/President changes; (5) repeal with substitution of Canadian-style capital gains tax payable at death on estate assets calculated using decedent's original tax basis ("carry over basis"), as proposed by President Trump; or (6) repeal with estate assets retaining the decedent's "carryover basis" rather than the present "stepped-up basis" to date of death values, causing beneficiaries to pay income tax at the time of sale on the appreciation in value. The insidious aspect of the repeal of the estate tax and conversion to an income tax on proceeds exceeding the "carryover basis", is that many closely held business owners, with proper planning, can avoid or minimize the estate tax and also achieve a stepped-up basis in the business, resulting in little or no income tax consequence on the sale following death. With carryover basis or Canadian-style capital gains tax at death, unless large exemptions are provided, business owners may very well be subject to greater overall tax than prior to the repeal of the estate tax.

Given the various tax scenarios, the likely continuation of the gift tax and the New York State estate tax, and the apparent continued availability of valuation discounts, there is significant benefit now to not taking a "wait and see" approach, but moving forward with active business succession and estate planning which thoughtfully considers the uncertainties. Building robust structures and documents that provide flexible options will result in cost savings (estate and income tax savings, reduction in conflict and potential litigation costs, asset protection from creditors, lower administration costs), and ensure the continuation of the business, maximize its value and preserve family relationships. There are planning opportunities after a crisis, but they pale in comparison to the opportunities available in planning and establishing a strong platform prior to the crisis. ■

Karen Schaefer
Partner
Lacy Katzen LLP
585-324-5718
kschaefer@lacykatzen.com
www.lacykatzen.com