Price & Farrington's Estate and Tax Planning *Fast* Faxts August, 2002

Estate, Tax, and Wealth Planning for Advisors and Clients

Price & Farrington
Attorneys and Counselors at Law
12501 Bel-Red Road, Suite 215
Bellevue, Washington 98005
425-451-3583
Email: pricefarr@aol.com

Pssst. Pass It On... 29 Questions To Ask If You Own a Family Business.

We encourage you to share this month's Fastfaxts with your business clients...

1. ***What is business succession planning?*** Business succession planning involves putting in place a variety of strategies to guarantee the survival of your family business when you retire or die unexpectedly. The following questions will help you decide if you need business succession planning.

2. ***Have you planned how to transfer your family business to your heirs?*** Imagine you awake when you are 65 and decide that you want to turn over the reins to your children. Your business is worth in excess of $1,000,000. How do you get it to your children? Transferring a family business is a very time sensitive matter; the earlier one starts, the lower the risks.

3. ***If you die unexpectedly, can your family continue to run your business?*** If your family cannot run your business, who can?

4. ***If you die unexpectedly, will your family have sufficient liquid resources to hire someone to replace you?*** If your family cannot run your business without you, you should consider their liquidity needs. If there is no money to hire someone to run the business, life insurance might be needed.

5. ***If you die unexpectedly, and have partners, will they pay your family a fair price for your business?*** When you are gone, you need a mechanism to ensure that your family is treated fairly by your partners.

6. ***How do you protect your family in the event of your early death?*** The most effective form of protection for your family, or for you if you survive to retirement, is a well prepared buy-sell agreement.

7. ***How do you know if your buy-sell agreement is well prepared?*** Does your buy-sell agreement provide which events trigger the requirement that the remaining owners purchase the interest of the departing shareholder? These should include at least: (a) death; (b) disability; (c) incapacity; (d) bankruptcy; (e) loss of a professional license; (f) failure to properly carry out the owner's expected duties; and (g) retirement

8. ***Does your buy-sell agreement require the remaining owners to purchase the departing owner's interest when a "triggering" event occurs?*** There are two fundamental types of buy-sell agreements: voluntary agreements and mandatory agreements. A voluntary agreement means that at your death or retirement your partners will negotiate the purchase of your interest from your estate or you. A mandatory agreement mandates that the remaining owners purchase your interest. The problem with a voluntary agreement is that it is only an agreement to agree and doesn't adequately protect you or your family.

9. ***Is your buy-sell agreement adequately funded?*** Every buy-sell agreement should have provisions for the payment of the price of the departing owner's interest by the remaining owners. The typical methods are: (a) by appraisal; (b) book value; (c) a multiple of annual earnings; (d) replacement cost of hard assets; and (e) as agreed upon annually.

Book value, multiple of earnings (whatever "earnings" means) and replacement cost of hard assets are susceptible to manipulation and therefore risky. Appraisal and as agreed upon annually will generally aid in reducing the potential for conflict when a purchase is mandated.

"Someday, Son, this will all be yours – assuming I can get my father to give it to me."

10. ***Will you have enough income when you retire?*** It is never too early to begin accumulating wealth for retirement. In family businesses this is especially crucial because younger family members taking over the reins will resent the senior generation if they take an unreasonable amount of money from the business because they didn't plan ahead.

11. ***Do you have a management succession plan in place?*** Have you realistically determined who in the family is capable, if anyone is, of taking over the business when the senior generation retires?

12. ***Does your succession plan accommodate siblings with different skill levels or interest in the business?*** For a succession plan to be successful, the senior generation should take into account their children's different skill levels and interest in the business. If Susie will take over, that doesn't mean Jack, who is interested in the business, is ignored. Planning should be in place to avoid family conflict that could destroy the business.

13. ***Have you considered the impact of estate taxes on your family business?***

14. ***Are you willing to pay the costs of protecting your business for your family?*** As with all things, "you get what you pay for." The current costs of a business succession plan will be greater than the costs of not planning. The costs of not planning can turn out to be exhorbitant. They include a loss of the family business:

(a) to estate taxes; or

(b) due to a lack of liquidity to tide the business through the period following an unexpected death; or
(c) because there is no formalized arrangement to transfer ownership of a decedent's interest to the decedent's heirs; or
(d) because no one has been trained to replace the senior generation; or
(e) because the retiring owners demand too much from the business to allow the junior generation to earn a reasonable income for their services; or
(f) because sibling rivalry was not planned for.

15. ***Are you willing to make gifts of interests in the family business to your children, or trusts for their benefit, if you can maintain management control?*** Many family business owners don't know that they can begin transferring interests in the business when their children are four years old and still maintain control. Estate planning attorneys have devised many such strategies, but the question of whether you're willing to pay the costs of succession planning comes into play here.

16. ***How does your estate planning attorney let you give it away but maintain control?*** By helping you select the right choice of entity to operate the family business.

17. ***Do you know what the entity of choice is?*** The family limited partnership (FLP) and the limited liability company (LLC) are the entities of choice because of their superior asset protection characteristics and their income tax flexibility.

18. ***Do you know why an FLP or LLC provides better asset protection than a corporation?*** Say you own stock in a corporation. You are also the general partner in an FLP. You are sued. The creditor obtains a judgment against you and can take your corporate stock. All the creditor could do to your partnership interest, however, is to receive distributions that you would otherwise have received. The creditor can't vote, act as a general partner or even look at the partnership's records. A hollow victory when compared to the loss of your stock.

19. ***How does your estate planning attorney use an FLP or LLC to enable you to transfer interests but maintain control?*** Your attorney prepares a partnership agreement and has you transfer your financial and investment real estate into the partnership in return for 2% general partner interests and 98% limited partner interests. You then begin the process of gifting the limited partnership units to your children or to trusts for their benefit. Because you retain the 2% general partnership interest, you maintain control.

20. ***Do you have an overall estate plan in place?*** All of your estate planning documents must be designed to fit together to create a business succession plan that works. Your revocable living trust could be the owner of the general and limited partnership interests that you'll own. In that way, you, or your successor trustee in the event of your incapacity, are able to manage the partnership without the necessity of a conservator or guardian.

21. ***Do you know how your living trust will be designed to carry out your business succession plan?*** Assume your daughter will run the family business if you are unable to due to an early death or incapacity prior to your retirement. With the general partnership interests owned by your living trust, your daughter can be appointed by the terms of the trust as the successor trustee who takes over as the general partner. Sibling conflicts are reduced and the business is protected.

22. ***Are you willing to give up some control over the business?*** Children who are to succeed to the management of the business should be given increasing management authority in proportion to their skill and experience. This provides for trained management replacements and gives the children the knowledge that you respect them and have confidence in their abilities.

23. ***Are you and your spouse in agreement about the ultimate disposition of the family business?*** Too often the spouse who performs most of the management of the family business doesn't take into consideration the wishes of the inactive spouse. This may cause the business succession planning efforts to take longer, cost more or perhaps even fail.

24. ***Are you willing to face the reality that you will die or retire at some time?*** First generation family business owners are a unique breed of entrepreneur. Typically, both spouses have worked long and hard for the family business. They have sacrificed to grow the business and leave a legacy to their family. But when it comes time to begin the planning, they are always too busy. There's no sense of mortality and many plan "to die in the saddle."

25. ***Are you willing to deal with a certain amount of complexity in your business succession planning?*** More detailed business succession plans can provide more tax savings than simpler ones. But unless you are comfortable with the succession strategy you adopt to protect your family, the plan will likely fail.

"Someday, Son, this will all be yours – unless I can come up with a better solution."

26. ***Are you willing to pay the costs of business succession planning?*** Business succession planning may entail professional costs that the typical business owner isn't used to paying. One reason is that there needs to be a team of professionals working to design and implement a successful plan for you and your family. This is not the time to be "penny wise and pound foolish." A sound business succession plan is an investment that can pay off for you and your heirs for generations.

27. ***Are you willing to accept the advice of professionals?*** Owners of family businesses are the bedrock of the American economic system, employ most of the people in the country and are responsible for many innovations. But entrepreneurs can be difficult to counsel. The skills necessary for successful business succession planning are likely something the owner is unfamiliar with. It takes a leap of faith to accept the advice of others, but it is necessary to protect the business.

28. ***Do you have an estate planning team familiar with business succession planning?*** This can be a complex area involving accounting, insurance for liquidity, professional investment advice and the aid of an experienced estate planning attorney.

29. ***Are you concerned enough to take action?*** Your advisors' skills or the importance to your family of business succession planning are meaningless unless you take action. The most important aspect of business succession planning is for the owners to become convinced that they need to take positive steps to avoid their family business disappearing for lack of planning. ■

We help advisors help their clients plan to preserve the family business. Contact us for assistance.