

The Family Business:

Does Your Business Succession Plan Work For You?

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According to the nationwide study, "American Family Business Survey," only 30% of family businesses survive each generation.



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One of the reasons this transfer rate is so low is because the owners fail to adequately plan for their succession. Many owners simply wait too long to implement a Business Succession Plan so the business must be liquidated or sold to a non-family buyer in order to obtain funds to pay estate taxes which are generally due nine months after death. In other situations the next generation of owners must approach their bank or other lenders for the money. The result can be a company with a high level of debt upon which it is unable to make the principal and interest payments. The ultimate outcome may very well be the same, liquidation or sale.

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You may think that you and your partner can work out succession details when the time comes. However, you need to understand that the death, disability, or retirement of a partner or co-shareholder creates different objectives for each party. Even if your attorney has drafted a Buy-Sell Agreement to address the issues of ownership and management upon a future

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transfer of your business, the Agreement could contain unknown traps. The Transfer Plan that was originally designed for your fledgling business may no longer be appropriate for your current successful operation.

Suppose, for instance, that you and your co-owners run an incorporated business, a C Corp, a Sub-Chapter S Corp, or a Limited Liability Company (LLC). And, as is commonly the case, let's say that upon the death of any co-owner, your Buy-Sell Agreement requires the corporation to purchase the stock from the estate of the deceased shareholder. The corporation also owns life insurance on each shareholder in order to have sufficient funds to buy the shares. This type of arrangement is known as a "Stock Redemption" Agreement.

One of the problems with this buyout structure is that the surviving shareholder(s) do not get the benefit of an increase in the cost basis of their shares when the corporation buys the deceased shareholder's stock. This will be an issue if the surviving shareholders eventually sell their shares in the company as it will result in a higher capital gains tax bill.

But if the Buy-Sell Agreement had been set up so that the surviving owners personally purchased the stock from the deceased shareholder's Estate (rather than using the corporation to buy the stock), the survivors would get a "step up" in their cost basis from the shares purchased. Under this arrangement, called a "Cross Purchase" Agreement, the higher basis will mean a smaller capital gains tax when they later sell the stock.

For example, suppose each owner of a two-owner business had invested \$25,000 in the Company ten years ago, and the business is now worth \$2 million. At the death of one owner, the surviving owner is obligated to purchase the decedent's interest at fair market value under their Buy-Sell Agreement. The surviving owner pays a \$1 million to purchase the shares. He now owns 100% of the business, with a total basis of \$1,025,000 (\$1,000,000 paid plus the initial \$25,000 investment). If he then sells the business for \$2 million, a 15% capital gains tax will be due on \$975,000, for a tax liability of \$146,250.

Compare that to the scenario in which the Company buys the shares with the life insurance proceeds under a Redemption Agreement. The surviving owner still ends up owning 100% of the Company, but his cost basis remains at \$25,000. If he then sells the business for \$2 million, a 15% capital gains tax will be due on \$1,975,000, for a tax liability of \$246,250 — \$100,000 more than if he had purchased the shares himself.

There are, of course, many other tax and non-tax reasons to consider in determining what kind of Business Succession Plan makes the most sense for you. The Financial Strategies & Solutions Group works with a client's existing

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advisors to provide customized and comprehensive Business Succession and Continuity Services to help insure the survival of your business.

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