

# Business Succession Planning

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Mr. Blum founded The Blum Firm, PC over 40 years ago. The firm specializes in estate and tax planning and the related specialties of asset protection, business planning, business succession planning, charitable planning, family legacy planning, fiduciary litigation, and guardianship. The Blum Firm has grown to be one of the premier estate planning firms in the nation, known for creating customized, cutting-edge estate plans for high-net-worth individuals.

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# Business Succession Planning Roadmap

1. Start the Process
  2. Create an Action List
    3. Form a Planning Team
      4. Manage Expectations
        5. Identify the Issues
          6. Define the Desired Outcome
            7. Search for a Solution
              8. Get Buy-In From Key Stakeholders
                9. Address the Challenges
                  10. Implement the Solution

# Statistics

- 90% of American businesses are family-owned or controlled.
- 30% of private business owners are over 67 years old and still actively running the business. Only 31% of them are working to educate and prepare family members to take over the business. Two-thirds lack a written succession plan. In most cases, the families are unprepared for a sudden or unexpected event.
- Large family companies have combined annual revenues of more than \$9 trillion and directly employ around 30 million people (almost 60% of U.S. workforce). This issue is not just for large or medium size firms. It's also critical for boutique and solo practices.
- 70% of business owners would like to keep the business in the family, yet:
  - Only 30% of family businesses survive the second generation.
  - Only 12% of family businesses survive the third generation.
  - Only 3% of family businesses survive the fourth generation.
- To beat the odds, you need a plan.

# 1) Start the Process

- The planner needs to be the instigator (or the “irritant”) to help get the process started.
- Watch for psychological barriers. Most founders aren’t wired to address long-term succession issues. They want to continue to go to work every day and grow the business. They believe they are indispensable.
  - Charles de Gaulle (former leader of France): “Cemeteries are full of indispensable people.”
- Expect denial—expect that the founder hasn’t come to grips that he won’t be there one day.
- This attitude leads to planning paralysis. It’s easier to just kick the can down the road than it is to get started on a business succession plan.
  - Scarlett O’Hara in *Gone With The Wind*: “I’ll worry about that tomorrow.”

## 2) Create an Action List

- Discuss where business succession fits into the overall estate planning process.
- Make a list of all the tasks, and then prioritize them.
- Put the tasks that are easiest to complete first. This creates momentum, and the client feels as though he's accomplishing something.
- Business succession is usually the last step. If you did business succession first, you'd get bogged down and end up not getting other things done.
- At the end of each meeting, set the time and agenda for the next meeting. We must keep the ball rolling so the client stays engaged and deals with this.

## 3) Form a Planning Team

- Business succession isn't the kind of planning that involves just the patriarch and the lawyer like doing a Will. It takes a team. Who goes on the team is determined case by case. There's no set answer.
- It's critical to include an advisor with a long-standing relationship with the family. This might be a lawyer, CPA, financial advisor, or life insurance professional. There needs to be someone on the team who the family trusts and who has a high degree of credibility with the family.
- The latest trend is to also include an outside consultant, such as a family business consultant who understands and can address all the family dynamics that are at play.
- You need to decide who's going to be quarterback.

## 4) Manage Expectations

- At this point in the process, before you embark on the legwork, it's important to manage expectations.
- When it comes to business succession, there is no perfect solution. It'll likely be impossible to achieve perfect equality between children, and no one will get everything they want.
  - Don't confuse the concepts of what's "fair" with "equal." In this case, fair very likely won't be perfectly equal.
- It's also important that everyone understands that putting a business succession plan in place is not a quick project. It's a process that evolves over time and includes multiple meetings.
- It's impossible to predict how long it'll take at the outset, but it'll likely be months, not weeks, to develop the plan, and years to properly implement it.
- There are no standard forms or fill-in-the-blank succession documents.



## 5) Identify the Issues

- We can't craft a solution until we know the problem, and no two situations are alike.
- We want to identify who the key stakeholders are and interview them individually to learn their concerns and goals for the plan. Interviews are often conducted by an objective consultant who has experience dealing with family businesses.
  - Founder
  - Founder's spouse
  - Children
  - In-laws
  - Key employees

## 6) Define the Desired Outcome

- Because no two succession plans will be identical, we need to remain flexible in the idea of what will mean success for each family.
- There are some factors that are common within many effective succession plans:
  - The business is managed by people who have the right skill set.
  - The business generates cash flow for all of its owners.
  - There is an exit strategy in place for those who decide they want to get out.
  - The business is just a portion of each owner's overall financial picture.
- Sometimes these factors are unattainable, and a sale of the business may be the best option. I know some business owners will want to stipulate that the business should never be sold, but even the Rockefellers sold Rock Center.

# 7) Search for a Solution

- There are 3 primary choices in the toolbox when thinking about succession planning:
  - Transfer the business to a family member/family members.
  - Sell the business to people within the business.
  - Sell the business to an outside party.
- Other aspects of the solution: If the children are going to keep the business and some are active in the business while others are not, explore how to create a cash flow for the children not active in the business. Are there assets that you can distribute to the owners (such as real estate that can be leased back to the company on a long-term lease)?
- Also look to life insurance. Life insurance proceeds can provide cash to the children not active in the business.

## Ownership Versus Management

- The founder's estate plan determines who gets ownership of the company, but that's different from who will manage it. Owners should not automatically be the managers if it's not in their skill set.
- Ownership Versus Governance—The business needs to run like a business and not like a family. Who will establish policies and provide corporate governance?
  - Who will make up the Board of Directors?
  - Who will choose the Directors?
  - Consider different classes of stock. Owners of voting stock can vote for Directors; owners of non-voting stock can't.
  - Consider leaving the stock to a trust for the benefit of the family with a carefully-selected trustee who'll vote the stock.
- Consider the timing—when the change in control of the business should happen. It's often best to transfer control while the founder is alive so that he can participate in the process and influence the stakeholders. The founder is the “glue” that keeps everyone together and makes the process a smoother transition.

- Richard Rainwater, author of *Masters of our Time*: “What has always struck me as odd is that if you look at public corporations, even corporations that begin as family businesses, the way they promote people is based on skill, not bloodlines. But most families continue to make decisions on who will manage the fortune based on bloodlines.”
- Warren Buffett requires the managers of his Berkshire Hathaway companies to submit a succession plan and update it regularly. He sends his “all star” managers a memo every 2 years asking their recommendation as to “Who would take over tomorrow if you should become incapacitated tonight?”

## Life Insurance

- Life insurance can play an important role in the solution.
  - If there are children who will not be involved in the business, life insurance can provide a cash flow for them.
  - An Irrevocable Life Insurance Trust (“ILIT”) can be a source of liquidity to pay estate tax.
  - An ILIT can also be a source of liquidity to “equalize” inheritances.
  - Key person life insurance (with the company as the owner and beneficiary) can provide the business with liquidity to cushion the loss and help offset any costs of losing a founder or other key employee.
- A buy/sell arrangement can be crucial to the success of a succession plan, especially if funded with life insurance.

## Buy/Sell Agreements

- Written agreement in which each owner of a business agrees that, upon occurrence of a triggering event, such as death, disability or retirement, his ownership interest in the business will be sold to the other parties.
- The Buy/Sell Agreement will set the sales price or a methodology for determining it (such as a formula or an appraisal process).
- If the Buy/Sell Agreement sets a specific sales price, get an appraisal every 3 years (or more often if circumstances warrant) and update the buy/sell agreement.
- Sometimes family businesses and family members create buy/sell arrangements so that the ones in the business can buy out the ones not in the business after a death. The non-active sibling sells and gets cash. The active sibling buys and gets control.

## Types of Buy/Sell Agreements

- There are two main types of Buy/Sell Agreements: Entity Purchase and Cross Purchase.
- Each type has advantages and disadvantages.



## Entity Purchase Buy/Sell Agreement (also called Company Redemption)

- The company buys the owner's share upon a triggering event.
- If the company is a corporation, it's often called a Stock Redemption Agreement.
- If the company is a partnership, it's often called a Liquidation of Interest.
- When the company buys an owner's share, the ownership percentages of the other owners' interests increases but the basis remains the same.
- Be sure to coordinate the buy/sell agreement with the existing governing documents for the entity. For example, an LLC company agreement might include right of first refusal provisions.
- If life or disability insurance is used to fund the buy/sell agreement, the company holds insurance on each owner and uses the proceeds to purchase the deceased or disabled owner's share.

- Be aware that the infusion of life insurance proceeds into the company generally increases the value of the company for estate tax purposes.
- In the *Blount* case, the Tax Court held that life insurance proceeds paid to the company increased the company's fair market value in the deceased owner's estate.
- The 11<sup>th</sup> Circuit reversed the Tax Court, rejecting the inclusion of the insurance proceeds in the computation of the company's fair market value.
- *Connelly* (E.D. Mo. 9/2021) agreed with the Blount Tax Court that the life insurance proceeds increased the estate tax value of the company, holding that the 11<sup>th</sup> Circuit's reasoning is "demonstrably erroneous."
- Consider the harsh outcome if a decedent's estate bears a much higher estate tax bill, yet the amount paid to the estate for its interest in the company is locked in by the Buy/Sell Agreement.
- This issue may be avoided by using a Cross Purchase Buy/Sell Agreement.

## Another Concern With Entity-Owned Life Insurance

- Tax Trap: The death benefit proceeds received by a business in an Entity Purchase buy/sell arrangement will be taxable unless the provisions of IRC 101(j) are satisfied.
- In 2006, subsection (j) was added to IRC Section 101 (relating to Certain Death Benefits).
  - Applies to employer-owned life insurance contracts issued after Aug 17, 2006.
  - Death benefit proceeds are subject to income tax to the extent the proceeds exceed the amount the policy holder paid for it unless an exception applies.
- Exceptions:
  - The insured was an employee at any time during the 12-month period before the insured's death.
  - The insured is a director or highly-compensated employee of the company at the time the contract is issued.

- The death benefit proceeds are paid to: a member of the insured's family; the insured's designated beneficiary under the insurance contract; a trust established for the benefit of any such member of the family or designated beneficiary; or the insured's estate.
- The death benefit proceeds are used to purchase an equity (or capital or profits) interest in the company from such family member, designated beneficiary, trust, or estate.
- For an exception to apply, certain notice and consent requirements must have been met.
  - The company must notify the employee that the company intends to insure his life, the maximum amount for which the employee could be insured, and that the company will be the beneficiary of the policy.
  - The employee must then consent in writing to being insured and that the coverage may continue after the insured terminates employment.
  - Notice and consent must be completed before the policy is issued.

- An employer that owns life insurance on an employee issued after August 17, 2006, must file IRS Form 8925 annually.
  - Form 8925 must be attached to the employer's annual income tax return each tax year the contract is owned.
  - The form is short and simple—the number of policies and the total face amount of the policies.
  - Note: Any material increase in the death benefit or other material change to a pre-August 17, 2006, policy will cause it to be treated as a new policy and the policyholder is required to file Form 8925.
- In addition to an Entity Purchase buy/sell arrangement, IRC Section 101(j) would also affect situations where a company owns key person life insurance on an employee.

## Cross Purchase Buy/Sell Agreement

- Owners A, B, and C agree to buy out each other's share upon a triggering event (instead of the company being the buyer).
- Life insurance is often used to fund a Cross Purchase Agreement. Owner A owns policies on Owners B and C. Owner B owns policies on Owners A and C. Owner C owns policies on Owners A and B. Premiums can be paid with their own money or with bonuses from the company.
- An income tax advantage of this type of Buy/Sell Agreement is that the survivor's basis in the interest acquired is increased by the price paid.
- Note that although the lower premiums of term life insurance can be more attractive, term rates can often become very costly to renew past the initial term limit. The upfront costs of permanent life insurance may end up being a smarter financial move in the long run.
- Life insurance proceeds do not go into the company and, therefore, cannot increase the value of the company for estate tax purposes.

## Major Issue with Cross Purchase Buy/Sell Agreements

- What if one of the buyers does not use the designated funds to purchase the life insurance?
- Or, once the insurance is purchased, a new owner borrows against the policy and the policy lapses!

## Ensuring Life Insurance Funding

- One or more trusts may be created to own the policy for the benefit of the would-be purchaser.
- The trustee of the trust could be the CFO of the entity, a bank, or other person.
- Alternatively, the entity could own the policy as nominee for the purchasing owner.



## Tax Differences of Buy/Sell Agreement Types

- The different types of buy/sell arrangements can have drastically different tax impacts for a surviving partner in the future.
- Example with Entity Purchase: Shareholders A and B each hold 50% of the shares. Their basis is \$10,000, respectively. Shareholder A dies, and the corporation buys back all of Shareholder A's shares for \$200,000. Now Shareholder B owns 100% of the shares. When Shareholder B later decides to sell the company for \$400,000, he will have \$390,000 of gain because his basis remains at \$10,000.
- Example with Cross Purchase: Shareholders A and B each hold 50% of the shares. Their basis is \$10,000, respectively. Shareholder A dies, and Shareholder B uses life insurance proceeds to buy Shareholder A's shares for \$200,000. When Shareholder B later sells the corporation for \$400,000, he will have \$190,000 of gain because his basis increased to \$210,000 upon his purchase of Shareholder A's shares.

## Where the estate is obligated to sell at a price set in a buy/sell agreement

- Case law based on IRC Section 2031 requires:
  - Price is fixed or determinable.
  - Agreement was binding on the decedent during his or her lifetime and upon death.
  - Represents a “bona fide” business arrangement. See *Estate of Lauder v. Commissioner*, 64 T.C.M. 1643 (1992).
  - Not be a testamentary device to pass the interest to the natural objects of the taxpayer’s bounty for less than adequate and full consideration.

- IRC Section 2703 expands on the “valid business purpose” requirement in situations of an intra-family transfer of closely-held business interests and adds:
  - Bona fide business arrangement.
  - Not a device to transfer the property to members of the decedent’s family for less than full and adequate consideration.
  - Terms are comparable to those entered into by persons in an arm’s-length transaction.
- Regarding price, query whether it is possible to establish arms-length terms without establishing that the price equals fair market value.

## What if an owner retires in a funded Cross Purchase arrangement?

- If an owner retires rather than dies, you'll want to unwind the buy/sell arrangement. Each owner will be left with a policy on the other, and they'll want to swap policies. The policy swap is a taxable event. If the policy received has a higher value than the basis of the policy given up, then there is taxable gain.
- To avoid owing tax as a result of the exchange, you will want to first attempt to minimize the gain on the swap. For example, if the value of a policy is too high and would create a tax liability on the recipient of that policy in a swap, the policy owner could borrow against the policy and bring down the value before swapping.
- After the swap, each owner will own his own life insurance policy which can be used for other estate planning purposes.

## Planning Tip: Use caution with Entity Purchase arrangements when a family-owned business is or has been a C corporation

- The purchase by a corporation of its own shares is treated as a dividend unless it qualifies for one of the exceptions allowing it to be treated as a sale or exchange of shares.
  - Dividend Treatment – C corporations: Taxed at 20% if in the highest tax bracket (possibly 23.8% with the net investment income tax), with no offset for basis.
  - Dividend Treatment – Former C corporations: Tax free to extent of Accumulated Adjustments Account. Taxed at 20% or 23.8%, as applicable, to the extent of earnings and profits. Thereafter, as a sale or exchange.
  - Sale or Exchange Treatment (Capital Gains Treatment): Taxed at 20% if in the highest tax bracket (possibly 23.8% with the net investment income tax), with an offset for basis.
- An often-relied-upon exception is IRC Section 302(b)(3) which provides that a redemption **in complete termination of a shareholder's interest** is treated as a sale or exchange of shares.

- When a family member of the deceased shareholder owns shares of the corporation, the deceased shareholder's estate will be deemed to also own those shares, so it's not a complete termination of the deceased shareholder's interest after all!
- For example, assume Father owns 80% of the shares and Son owns 20%. At Father's death, all of Father's shares are redeemed by the corporation under an Entity Purchase Agreement.
- It *appears* to be a complete termination of the estate's interest in the company which qualifies for sale or exchange treatment. However, under the family attribution rules, Son's shares are constructively attributed to Father's estate.
- Because it was not a complete termination of the deceased shareholder's interest, the redemption is fully taxable to Father's estate as a dividend, with a disadvantage of no offset for Father's basis in the corporation.

- Generally, a redemption will be respected where the shareholder and his family own less than 50% of the stock after the redemption and the shareholder's voting percent, both with and without attribution, has been reduced by at least twenty percent (20%) as a result of the redemption.

## Planning Tip – IRC Section 303 permits a tax-free redemption of stock to pay estate tax

- IRC Section 303 provides an exception to a corporation's stock repurchase being treated as a dividend.
  - Stock owned by a deceased stockholder can be redeemed without being treated as a dividend to the extent of death taxes (including interest), funeral expenses, and administration expenses.
  - It is not necessary that the estate or the stockholder actually use the proceeds from the redemption to pay the death taxes, funeral expenses, or administration expenses.
  - The stock received a step-up in basis at the shareholder's death. Assuming the redemption is made shortly after death, there would be little or no capital gain tax due.



- Any redemption in excess of the amount of death taxes, funeral expenses, and administration expenses will fall under the normal redemption rules and may be treated as a dividend.
- To qualify for a Section 303 redemption, the value of the shares that are includable in the decedent's estate must exceed 35% of the decedent's gross estate less deductions allowable under Sections 2053 and 2054.

## Tax Trap – Funding a Cross Purchase buy/sell agreement with existing life insurance policies could cause two issues

- First, if both owners have existing policies that are used to fund the agreement, the swap is a taxable event.
  - If the value of the policy received exceeds the basis of the policy given up, the difference is taxable income.
  - This is the same situation as our earlier scenario, ‘What if an owner retires in a funded Cross Purchase arrangement?’
- Second, part of the death benefit proceeds could be subject to income tax under the transfer-for-value rule.
  - The rule says that once a life insurance policy is transferred in return for valuable consideration of any kind, the policy loses its tax-exempt status and the death benefit in excess of basis will be subject to income tax.

- For example, Owner A owns a policy on his own life and transfers the policy to Owner B. Owner B owns a policy on his own life and transfers the policy to Owner A.
- It may appear that there was no consideration because no funds were exchanged; however, a swap of one asset for another is a taxable sale unless a specific exception applies. No exception applies here.
- When Owner A dies and Owner B receives the death benefit proceeds, the death benefit in excess of basis is taxable. The taxable death benefit is ordinary income.

- There are exceptions to the transfer-for-value rule.
  - One exception is when the transfer is to the insured. This exception was applicable in our ‘What if an owner retires in a funded Cross Purchase arrangement?’ scenario earlier.
  - Other exceptions:
    - The basis to the transferee is determined in whole or in part by reference to the basis of the transferor.
    - The transfer is to a partner of the insured or to a partnership in which the insured is a partner.
    - The transfer is to a corporation in which the insured is a shareholder.
    - Note: Transferring to a co-shareholder/fellow shareholder is not an exception.
- The easiest solution is to avoid transferring existing policies by purchasing new policies when funding a Cross Purchase arrangement.

# Back to our Search for a Solution

- We need to recognize when selling the business is the best solution. The patriarch may have psychological barriers to selling the family business.
- Selling the business during the founder's lifetime is much better than waiting to sell it right after the founder dies.
  - The founder is better able to articulate the opportunities for the business going forward than the heirs are.
  - The heirs don't speak with one voice.
  - Time of bereavement isn't the best time to do this.
- You want to choose the best time to sell and not be under pressure to sell at the time the founder dies and you're under the gun. (For example, a fire sale to pay estate tax). The timing of the sale is a strategic decision you want to be in control of.

## Pre-Sale Planning

- Before selling, you'll want to look for inefficiencies in the business and remedy them to maximize the sale price. Reduce overhead, shore up the management team, etc.
- The second part of this pre-sale analysis is minimizing taxes. Estate planning before the sale ("squeeze and freeze" planning) can reduce the amount of estate tax and, therefore, maximize the proceeds that the family gets to keep. You'll want to build into the plan for the wealth to pass down from generation to generation free of estate tax.
- Do the estate planning at a time when assets can qualify for the maximum amount of valuation discounts (known as "squeeze" planning). The earlier in the timeline, the better.
- With careful drafting, it's even possible for the founder to move the business out of the estate but continue to stay in control and have access to the assets for his needs (known as "freeze" planning).

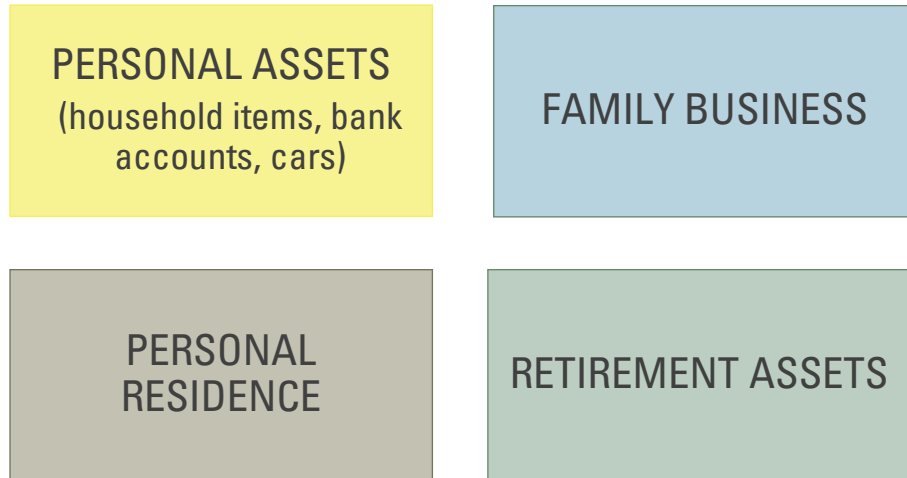
# A Tale of 2 Families

## Family 1 – The Baade Family

- Donny and Marie Baade own a business that has grown from \$35 million to be worth \$50 million along with \$4 million of other assets (home, bank accounts, cars, and other personal assets).
- They did “basic” estate planning and have Wills dictating that the ownership of the business will pass to their 3 children. The plan is that their oldest son will run the business and buy out the other 2 kids.
- They die and their estates owe \$11.3 million in estate tax. [\$54 million in assets less \$25.84 million exemptions, 40% tax]
- The kids don’t have \$11.3 million in liquid funds lying around, readily available and resort to a “fire sale” to quickly sell off the business to be able to pay the tax bill due nine months from death.

# Baade Estate

Assets Inside Estate  
(subject to 40% Estate Tax)



Assets Outside Estate  
(not subject to 40% Estate Tax)

TAX FENCE

Estate Tax = \$11,300,000



- Why didn't they move the family business out of their taxable estates? Common reasons are:
  - They had a basic estate plan in place and thought they had done what was needed. They'd checked estate planning off their "to do" list. ("I'm all set.")
  - They were under the misconception that in order to move the business out of their estate, they would have to lose access to or control of it.
  - They were intimidated by the cost of sophisticated tax planning to move the business out of their taxable estate, unaware that the cost of not planning would be far greater.

## Family 2 – The Goode Family

- William and Anna Goode have a similar situation as the Baades. They also own a family business that has grown from \$35 million to now be worth \$50 million and own \$4 million of other assets (home, bank accounts, cars, and other personal assets). They also plan to leave ownership of the business to their 3 children. The oldest son plans to run the business and one day buy out his siblings.
- Back when the business was worth \$35 million, they engaged in business succession tax planning (specifically, “Squeeze & Freeze” planning).

## The “Squeeze”

- The Goodes first engaged in planning to “squeeze” down the value of the business to be able to move as much as possible out of their estates.
- They examined the entity structure and created a structure that would qualify for the best possible valuation discount.
  - If an LLC or limited partnership, examine the agreement to ensure that the entity will qualify for an optimum valuation discount.
  - If a C corporation, transfer stock to a limited partnership.
  - If an S corporation, reorganize the structure to establish 1% voting and 99% non-voting shares. Perform tax planning with the non-voting shares, which qualify for a valuation discount.
  - For the Goodes, they created a limited partnership to own their business.

## The “Freeze”

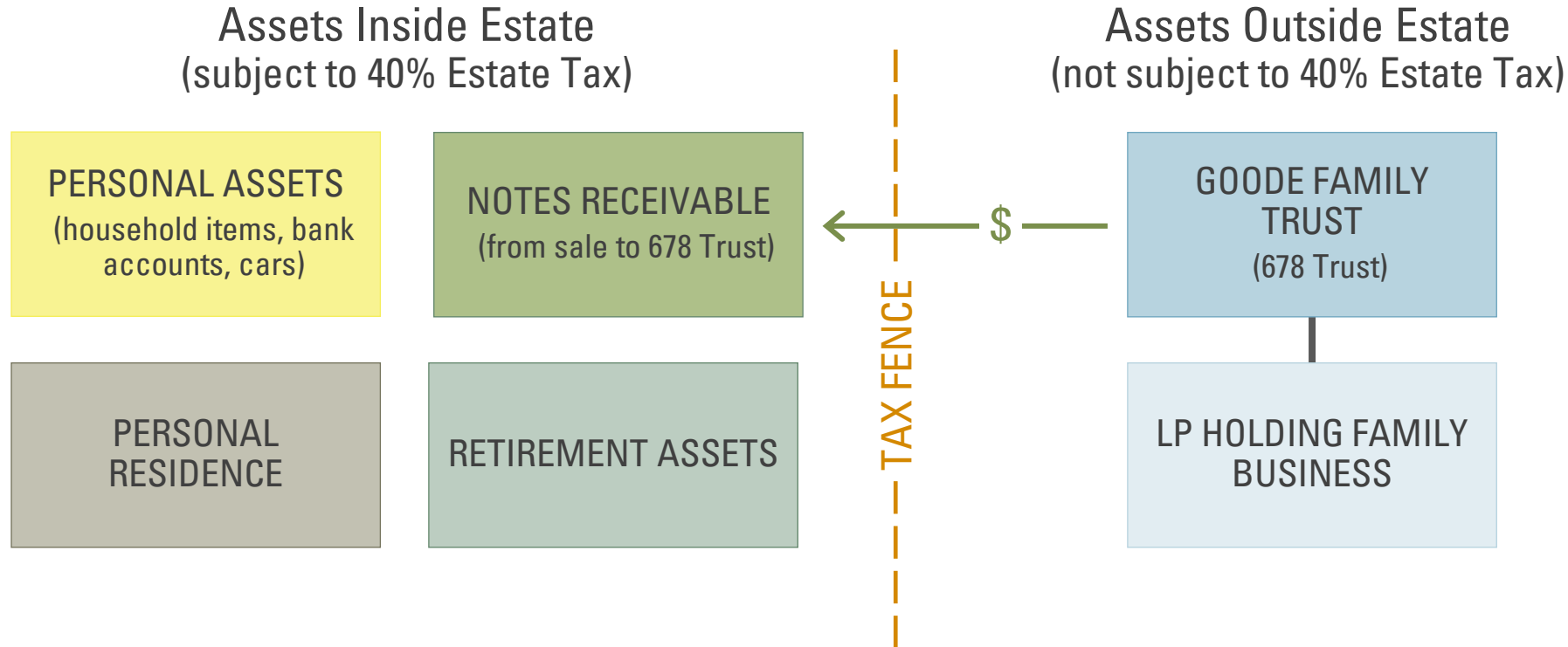
- There are several techniques available to move the assets out of your estate and “freeze” the value of the estate, and they can be used in any combination of gifts and sales.
  - Gifts/sales to a Defective Grantor Trust (“DGT”) for the benefit of your children.
  - Gifts/sales to a Spousal Lifetime Access Trust (“SLAT”) for the benefit of your spouse.
  - Sales to a 678 Trust (also called a Beneficiary Defective Trust or “BDT”) for the benefit of you and your family.
- The Goodes choose a 678 Trust because they want to continue to be able to benefit from the assets held in the limited partnership. A 678 Trust is a unique vehicle that saves estate tax and protects assets from creditors, yet you can:
  - Stay in **control** of the assets;
  - Continue to have **access** to the assets for your needs; and
  - Retain **flexibility** to alter the plan if you later change your mind on where/when/how you want the assets to pass.

- Because the 678 Trust (the “Goode Family Trust”) is created by a third-party trustor, William and Anna Goode can be beneficiaries of the trust. As beneficiaries, they can receive distributions for health, education, maintenance, and support.
- The limited partnership interests, assuming valuation discounts of 35% for lack of marketability and lack of control, have a total value of \$22.75 million. [\$35 million less 35%]
- The Goodes each sold their 50% limited partnership interest to the Family Trust for \$11.375 million in exchange for promissory notes.
- They’ll use the note payments they receive to cover their living expenses and income taxes, “burning” down their taxable estates over time (hence the term “Squeeze, Freeze, & Burn”).
- Once the notes are paid off, they’ll receive trust distributions to cover their needs.

## After Squeeze & Freeze Planning

- The Family Trust will make principal and interest payments on the promissory notes payable to the Goodes.
- They have not lost access to the business's profits. In addition to note payments, the Family Trust can make distributions to them as needed for their health, education, maintenance, or support.
- Once the Goodes sell the family business to their oldest son, the \$50 million proceeds go into the limited partnership. The Family Trust uses the proceeds to pay off the promissory notes (\$11.375 million each). The rest of the proceeds (\$27.25 million) remain in the partnership (owned by the Family Trust), available to William and Anna as beneficiaries of the Family Trust.
- At William's and Anna's deaths, their estates owe \$364,000 in estate tax, assuming there's been no burn down of the notes yet. [\$4 million + \$11.375 million + \$11.375 million less both \$12.92 million exemptions, taxed at 40%]

# Goode Estate



\$22,750,000 from payment of prom notes  
\$ 4,000,000 other personal assets  
 \$26,750,000 total in taxable estate

Estate Tax = \$364,000

Note: This is a simplified presentation that omits reference to a second "Guarantor Trust" that will serve as guarantor for 10-20% of the notes.

## 8) Get Buy-In From Key Stakeholders

- After determining the solution, the next step in this process is to get buy-in from everyone. First, we want the founder's buy-in. Remember, he's the "glue."
- Next, we turn to the rest of the stakeholders. Conduct a "family meeting" with all the family members. Having everyone's support not only makes the planning process smoother but also increases the likelihood that the plan will ultimately be successful. It's best to have an independent party facilitating the family meeting, ideally someone with a family consulting background.
- We can't address business succession planning without also addressing family dynamics.
  - If the family governance system is weak and there's poor communication and lack of trust, the business will suffer.
  - Business succession planning and family governance planning go hand in hand.



## Family Advancement Sustainability Trust (“FAST”)

- Consider creating a trust to endow the cost of conducting regular family meetings and family enrichment activities.
- A Family Advancement Sustainability Trust (“FAST”) is the best way to pay for family meetings and other best practices of successful multigenerational families, such as:
  - Holding family meetings and family retreats
  - Family travel
  - Creating a curriculum and educating future heirs to become responsible inheritors
  - Establishing a system of family governance
  - Working to preserve the family’s history and heritage

- A FAST provides FUNDS:
  - Funds for future generations to use to prepare heirs to be able to successfully manage an inheritance
  - Fund family endeavors to keep the family together after the elder generation dies, such as family retreats and family meetings
  - Funds to train future generations on concepts like philanthropy and being responsible stewards
- A FAST provides LEADERSHIP:
  - Creates a leadership structure to ensure these activities happen, using a system of trustees and committees who are paid to run the FAST and charged with the responsibility for carrying out these tasks

# 9) Address the Challenges

- There are two specific challenges that are very common, so you'll want to be ready for them.
- The first inevitable obstacle is the founder's fears.
  - Some clients worry that their lives will be empty and boring or that they will no longer be welcome at the office. They worry about what they will do with their time.
  - Address the question of the role the founder will play in the business. It's better to shift day-to-day management responsibility to a successor management team. Will the founder be a director (helping establish policy/broad oversight)? Will he work on special projects? Note that a prospective buyer would consider it a valuable plus if there's a successor management team in place running the day-to-day.

- A popular option is for the founder to open a family office to be responsible for philanthropy and investing and things outside of the family business. This provides a transitional environment for the founder to not feel as though their skills are no longer needed. It also serves as important “family glue.”
- Don’t fail to address any fears the founder’s spouse may have—fears about how HER life will be impacted, especially if the founder is hanging around the house. “I married him for breakfast and dinner, not for lunch.”
- The second obstacle that you’ll inevitably face is family conflict.
  - Family members often have conflicting goals and visions for the future of the family business, and so there will be some disagreement.
  - Diminish the intensity of conflict by ensuring that everyone’s voice is being heard.
  - Focus on the positives and identify commonalities—the values that everyone shares—to get them to come together to work toward a solution.

# 10) Implement the Solution

- The final step in this planning process is to implement the solution. This step may seem pretty straightforward, but it's important to understand that implementing the plan may be a multi-year process.
- If the solution is to keep the business in the family, you start training the successor.
  - Invite to observe board meetings and management meetings.
  - Consider creating a "junior board." This might influence what they choose to study.
  - "Ride around in the truck" with the founder.
- Don't try to go it alone. Keep the planning team engaged to help guide the process and serves as a sounding board when challenges arise.

- Don't overlook the females in the family. Statistics show that females fare extremely well in taking over a family business. According to a Merrill Lynch study:
  - Women make more values-based decisions rather than just going for the bottom line. They see money as more than a way to finance the life they want to live but also as a way to meet commitments to themselves and to people and issues they care about.
  - Women live, on average, five years longer than men. Women may be around longer to run the business.
  - Women graduate in higher numbers from college and graduate school today than men (57% of recent graduates).
  - 42% of women ages 18-64 have a bachelor's degree or higher.
  - A mother typically spends a lot of energy maintaining the emotional cohesiveness of a family and keeping the peace among family members. This mindset can be a positive force in a business.

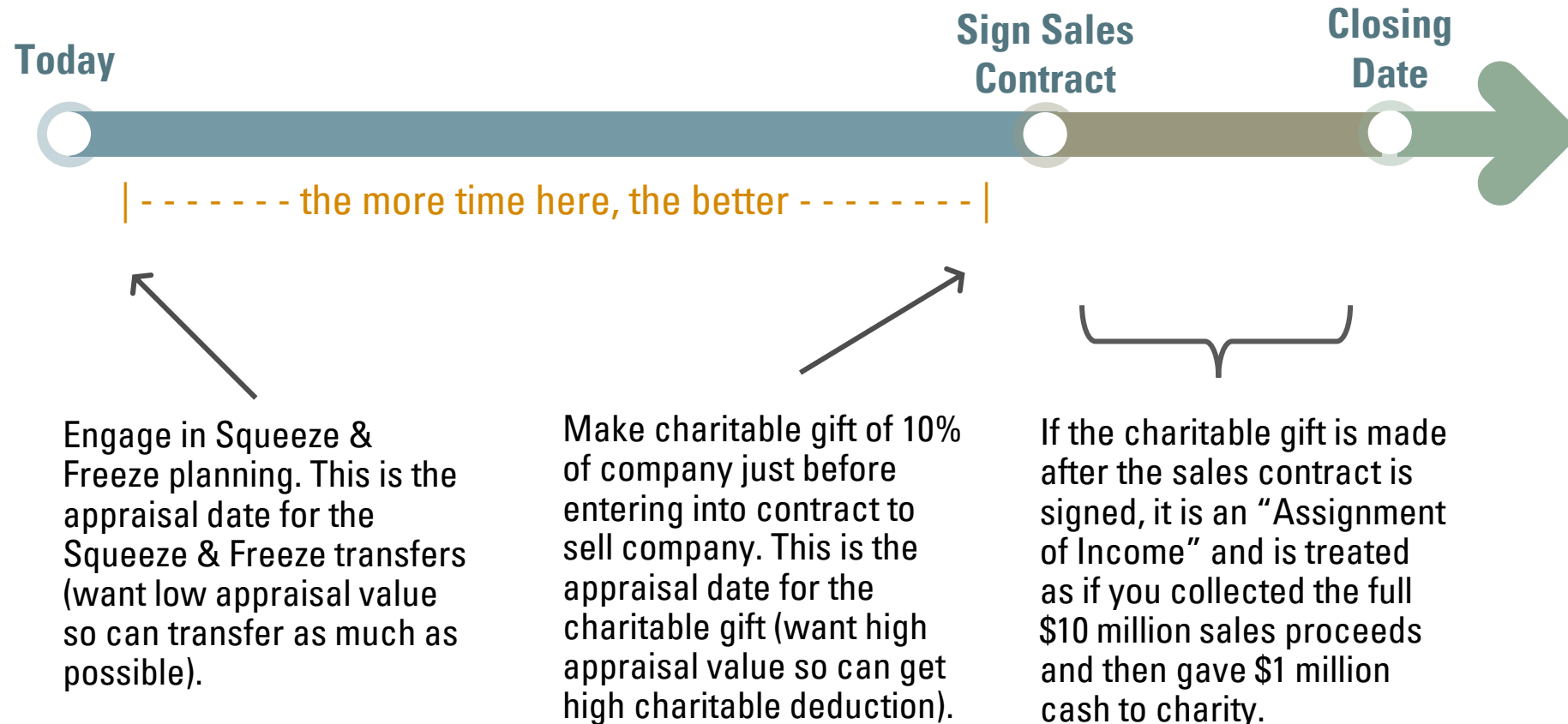
- Should the family business have a “no in-laws” policy?
  - Bringing in in-laws could create family disharmony (jealousy).
  - It would be hard to evaluate them objectively.
  - It would be hard to fire them if needed.
  - Instead of a son-in-law taking the reins, a no in-laws policy could lead to more daughters being groomed and taking over.
  - A “no in-laws” policy avoids complications upon divorce. (What to do with a former son-in-law manager?)
  - On the other hand, you may lose out on the best choice for a successor.
  
- A clear policy makes it easy to manage expectations.
  - Set the policy in advance, before you have any in-laws.
  - Adopt a family policy that each owner will cover business ownership in a pre-nup so ownership stays in the family when a business owner’s marriage terminates.

## Solutions Involving Charitable Planning

- If the business succession solution involves selling the business, that often provides the owner with liquidity to satisfy long-held desires to make substantial charitable contributions.
- Rather than close on the sale and then make the charitable gift, there's a better order of events.
- Consider this example:
  - Owner sells business for \$10 million and then donates \$1 million to charity, leaving the owner with \$9 million before tax.
  - Owner reports income of \$10 million (for simplicity, assume a zero basis), and takes a deduction for the \$1 million charitable gift, paying tax on \$9 million.
  - Rewind the clock: owner donates 10% of the business just prior to entering into the sales contract.
  - At closing, owner receives \$9 million, and the charity receives \$1 million. Owner reports income of \$9 million and takes a deduction for the charitable gift of a 10% slice of the business (appraised at close to \$1 million in value), paying tax on approximately \$8 million.
  - Bottom line: by making the gift to charity BEFORE the sale, owner saves income tax on \$1 million of the sales proceeds.



# Timeline for 10% Charitable Gift



- To take these tax savings up to the limit, consider these two recent examples where the owner gave away the entire business: electronics giant Tripp Lite (\$1.6 billion value) and outdoor apparel maker Patagonia (\$3 billion value).
  - Barre Seid donated 100% of Tripp Lite to Marble Freedom Trust, a non-profit devoted to conservative causes. After the donation, the company was sold for \$1.65 billion, with all the proceeds going to Marble Freedom Trust free of income tax.
  - The Chouinard family donated 2% of their Patagonia stock (all the voting shares) to a new Patagonia Purpose Trust, and 98% of their stock (all non-voting) to Holdfast Collective, a non-profit devoted to protecting the environment.
- Neither family will pay any tax when Marble Freedom or Holdfast sells the business it owns, and all the proceeds will be committed to causes important to that family. Ironically, those causes are opposite: Marble Freedom funds efforts to stop action on climate change; Holdfast funds efforts to combat climate change.
- By donating a business to support charitable causes, the entire amount of the sales proceeds goes to charity without diminishing any of it to pay income tax on the sale.

- Note that since these two nonprofits are politically focused, they are 501(c)4 rather than 501(c)3 organizations, so the contributions to them are not deductible from income tax, but the income they earn is exempt from tax. Furthermore, supporters can donate assets that the 501(c)4 sells the business and avoids capital gains taxes on the sale.
- In contrast, if the donation is to a 501(c)3 charity, the contribution is tax deductible in addition to the sales proceeds being free of income tax. Be aware that contributions during life to a 501(c)4 also get a gift tax charitable deduction, but contributions to a 501(c)4 at death do not get an estate tax deduction. If you give the business to a 501(c)4 during life but stay in control of the business, the business may be included in the estate under Section 2036 with no offsetting charitable deduction.
- Here's the key takeaway: if you sell a business or other asset and want to commit part or all of the proceeds to charitable causes, make the gift BEFORE you sell.

# Learn From Other Families

## Feil Family of New York – A Succession Plan That Failed

- Louis Feil was a real estate mogul and created a dynasty reported to be worth \$7 billion. Patriarch Louis died in 1999, matriarch Gertrude in 2006. The family business passed to the 4 kids (1 son and 3 daughters) in equal shares.
- The only son, Jeffrey, was groomed to take over. Jeffrey controlled the cash flow and distributed just \$300,000 each year to each of the 4 kids. He reserved the majority of the business's cash to buy up more deals.
- Jeffrey was paid a salary which provided him with a cash flow. For the 3 sisters, their only cash flow from the family business was what Jeffrey chose to distribute.
- The 3 sisters took Jeffrey to court, alleging that he was starving them out so that he could buy them out at a discounted price. One sister had a terminal illness and expressed concern that her family will be unable to pay their estate tax.
- The family lost its glue when the parents died. Jeffrey was quoted as saying that when his father died, "The binding of the book came loose," and then when his mother died, "The pages fell out."
- A better succession plan could have provided cash flow for all the business owners, such as with life insurance. Or, sell some assets and make cash distributions to all 4 kids. The way Louis Feil set it up is a recipe for disaster.

## Johnson & Johnson – A Succession Plan That Works

- Johnson & Johnson was started by 3 Johnson brothers in 1886 as a manufacturer of surgical dressings. The company attributes part of its survival to the successful implementation of succession planning programs.
- One of their programs grooms future leaders for the company. A selection committee identifies employees who have the potential to be future leaders.
- The selection committee presents them to the CEO and a corporate governance committee for review. The CEO and this governance committee pick the candidates.
- These future leaders have career paths mapped out for them and are provided continuous training including general management training programs and individualized training for their specific business sector.
- There are two sets of candidates. One set is employees selected for top management positions. The other set is called “change drivers” who go through a different curriculum. The change drivers aren’t trained for a specific department but are trained for the entire operations of the company.
- The result is that there are smooth leadership transitions within the company. Over the years, half of the company’s CEOs have come from within the company.

## Pac Paper, Inc. – Decided Best Solution Was to Sell

- Pac Paper, Inc. in Vancouver, Washington was started by David Morgan's father over 40 years ago. They manufacture paper sleeves for coffee cups and other paper products.
- David was receiving calls from competitors wanting to buy the company. At the time, he had no plans of selling the company away from the family.
- Those calls from buyers started him thinking about the future of the company and who would run it after him. He realized that the next generation wasn't in a position to take over leading the business. And, he knew that good offers wouldn't stay on the table forever.
- So he and the other co-owners agreed to sell the family business to a rival company. Even though the business had been in the family over 40 years and David couldn't imagine that it would no longer be in the family, or that he would be the one to sell it, he knew that a sale was the best way to keep family unity going forward.

# Business Succession Planning Roadmap

1. Start the Process
  2. Create an Action List
    3. Form a Planning Team
      4. Manage Expectations
        5. Identify the Issues
          6. Define the Desired Outcome
            7. Search for a Solution
              8. Get Buy-In From Key Stakeholders
                9. Address the Challenges
                  10. Implement the Solution

# Questions?

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