



BASICS OF BUSINESS SUCCESSION & ESTATE PLANNING

-GETTING YOUR PERSONAL & PROFESSIONAL HOUSES IN ORDER-

As a small business owner, you have successfully built your company and have probably set up a structure that consists of a sole proprietorship, a partnership or some other form of a closely held business. In a competitive business environment and through fluctuating economic times, you struggle like most of us to attract new customers, serve your clients, make payroll, keep the lights on and have enough left at the end of the day to provide for you and your family. ***But have you taken the simple steps to secure your business and your financial well-being, through a well-designed estate and business succession plan?*** There are a wide array of estate planning issues that encompass both personal matters and business succession. These include planning for the continuation of your business and building contingencies in the event of your retirement, disability, or death. You may want to see the business handed down to future generations, new business partners added, or sold to employees that helped build the company. Whatever your wishes, it is important to have a plan in place to provide for a smooth transition of the business.

Basic, yet necessary, estate planning documents are a Power of Attorney, Health Care Proxy, Disposition of Remains Appointment (DORA) and a Will. A Revocable Living Trust ("RLT") can be used, as opposed to a Will, as an alternative means of estate disposition. Of equal importance is its value during your lifetime; transferring the title of assets into the name of your RLT allows you to be the trustee as well as the beneficiary, but appoints successor trustees to manage assets in the event of your incapacity. A Limited Liability Company ("LLC") is an additional estate planning and business structure that may have added value in the context of your enterprise. For those of you that already have established an LLC, does your operating agreement cover succession planning, or do you have a buy/sell agreement in place? This article will address some of these fundamental issues in planning your estate when a business is involved.

Advance Directives - Business Powers of Attorney

Studies confirm that nearly everyone will face at least a temporary disability at some point during their lifetime. More specifically, one in three Americans will face at least a 90-day disability before reaching age 65. Therefore, it is paramount that everyone has advance planning documents in place for financial and health care matters. For small business owner, any period of incapacity could spell disaster for the business.

A **Power of Attorney (POA)** is commonly used in estate planning to name an agent(s) to manage financial affairs if one becomes incapacitated. An essential part is appointing an individual or individuals, known as "fiduciaries," to act on your behalf. In a Will, the fiduciary is called an "Executor," and in a Trust, the fiduciary is called a "Trustee." In addition, there are other methods to appoint individuals to act on your behalf during your lifetime, as the need arises.

Through a Power of Attorney, you can appoint trusted individuals to manage financial decisions and transact business on your behalf. A **“General” Power of Attorney** gives an agent, known as your “Attorney-in-Fact,” the authority to make banking, real estate, and other transactions in your name. You may choose to have two separate Powers of Attorney, one for personal matters and the other one solely for business affairs, and appoint different individuals to take care of your personal and business matters. Think of some of the specifics of running your business such as negotiating contracts, accessing financial accounts, placing orders, writing checks and the completion of pending work. You can specifically tailor the language into your Power of Attorney to authorize your designated fiduciary to make decisions along these lines.

Powers of Attorney can be effective at all times, known as **“Durable” Powers of Attorney**, or only take effect under certain circumstances, like when the principal is not available or is incapable of making decisions, known as **“Springing” Powers of Attorney**. A common provision is that the Springing Power of Attorney becomes effective when a doctor signs a written statement that the principal is no longer able to manage his or her affairs. In this way, you can designate an Attorney-in-Fact, but delay the effective date of the appointment until such time as you become disabled or incompetent. While making decisions about Powers of Attorney and potential agents, people should think about the needs of the given situation and consider what kinds of powers they want to grant and when. It is also important to discuss the document with the person(s) being granted as agent under a Power of Attorney, so that individual has an understanding of what is expected. Generally, someone acting as agent is expected to make decisions in the best interest of the principal or the business. New York passed legislation in 2010 that made substantial revisions to the Power of Attorney statute and contains many provisions to safeguard the principal from abuse of authority by their agent.

A Durable Power of Attorney may allow you to avoid a costly and complicated **Guardianship** court procedure, which is necessary if an individual becomes incapacitated and does not have any advance planning directives in place. It can also prevent any difficulties involved with management of a business while a Guardianship is pending in the court. All Powers of Attorney end upon the death of the principal.

Other advance directives are important for personal estate planning, but not common for business purposes. A **Health Care Proxy** (HCP) or Living Will appoints someone to make health care decisions in the event that you are unable to do so yourself. A **Disposition of Remains Appointment** (DORA) provides that one can designate, in writing, a person who shall have the right to control one’s final arrangements.

Will

The primary reason for executing a Will is to provide instructions on how your assets are to be distributed among your beneficiaries. A Will is a written document which:

- Outlines how you wish to distribute your assets, including specific gifts of your tangible personal property;
- Outlines how you wish your business to be continued or its assets to be distributed;
- Designates an Executor or personal representative who is responsible for taking inventory of your property; preserving your estate; paying creditors, administrative expenses and death taxes; and disposing of the remainder of your property among your beneficiaries;
- Appoints Guardians for minor children in the event of the death of both parents; and
- Establishes trusts to protect assets.

Your Will can and should specify how you want your business interest(s) handled. Do you envision its continuation or would you prefer to detail how its assets should be sold and divided to your beneficiaries? If your intention is to continue the business, you can specify details of whom and how you would like to continue your business affairs (to work in conjunction with any operating or buy-sell agreements).

You can use your Will to establish a **Testamentary Trust** that will ensure that your assets are held, managed and distributed in the manner which you specify. You can direct that the Trustee of this Trust manage certain assets for the benefit of your family and/or other beneficiaries and distribute Trust assets at specific times and in the manner you set forth. For example, if you are concerned that your spouse may remarry after your death, you can create a Trust that provides income and principal for your spouse during his or her life, but preserves the remaining principal for your children upon his or her death. Likewise, if you are leaving assets to children, you will want to use a Trust to ensure that they do not receive the funds until they reach a certain age or level of maturity, or only for certain purposes such as support, maintenance, and education.

Revocable Living Trust

A **Revocable Living Trust** is a complete will substitute. It can control all of your assets both during your life and after your death. Here's how it works: when you set up your Revocable Living Trust, you transfer the title of all your assets (stocks, bonds, real estate, etc.) from your name to the name of the Trust. You then name yourself as the Trustee and beneficiary. This gives you, and you alone, total and complete control of all your assets.

Here's the difference, and the real benefit to you. When you die, there will be no assets left in your name, and therefore, no probate for your family to endure. Whomever you name as your successor Trustee will immediately gain control of your assets to distribute them according to your exact instructions. With a Revocable Trust your assets will go directly to your beneficiaries after your death. There will be no probate, attorneys' fees or court costs. There will be no court delay in distributing your assets, and all your estate planning wishes will be completely private. Furthermore, the Trustee will be able to ensure continuity of asset management during a period of incapacity.

Your Revocable Living Trust can also own your business interest by holding LLC interests in your Limited Liability Company, shares in your corporation, or interests in your partnership. Again, you maintain complete control of your business interest during your lifetime, as well as direct its disposition after you pass. In this way, you can control how these business interests will transfer to your heirs, as long as you comply with the appropriate operating agreement or buy-sell agreement. It could enable a seamless transition of critical assets necessary for continuation of your business.

Limited Liability Company

Some of you may already have formed a Limited Liability Company ("LLC") for business reasons. However, there are several advantages to using an LLC in the context of estate planning. An LLC will enable you to preserve significant management control over your property, while reducing your taxable estate, by transferring certain property to family members as gifts, without adverse transfer and income tax consequences. It will facilitate the making of gifts and may generate substantial valuation discounts with respect to gifts of Limited Liability Company interests. The LLC also avoids the compressed income tax rates applicable to trusts and the double tier tax applicable to C corporations. Unlike an S corporation, with an LLC there is no limit on the number of shareholders or the types of entities that can hold LLC interests. Finally, the LLC provides investment flexibility.

Business Succession Planning

Business Succession Planning refers to the practice of using estate planning strategies to increase the chances for the survival of one's family business upon disability, retirement or death. Succession planning helps to ensure that the necessary accommodations are in place should one die unexpectedly or if a similar

unexpected event should occur. A properly designed plan will integrate the business aspects with the overall objectives of the estate, to form one cohesive, overall plan.

Common goals for business owners include:

1. Provide sufficient income for a business owner's retirement;
2. Ensure that one receives a fair price for ownership interests upon retirement and that the family receives a fair price in the event an owner passes away prematurely;
3. Allow a smooth transition between management;
4. Reward children in a business, and compensate children outside it.

Although a good business succession plan may be perceived as costly, the investment is small when compared to the potential consequences of not planning.

A well-designed business succession plan will address:

- Retirement income of the current owners
- Estate taxes
- A lack of liquidity to carry the business through the transition period and purchase interests
- A formalized arrangement to transfer ownership and management control
- The senior owners demand for too much from the business, preventing junior owners from earning a reasonable income
- A sibling or family rivalry
- Family versus non-family ownership

Other Key Features of a Business Succession Plan:

- < Encourages businesses to determine who is realistically capable of taking over and running the business once the senior generation is no longer there
 - Should take into account the different skill levels and interest in the business of the potential successors. For example, if there is a daughter who is the heir apparent to take over the business and a son who is equally as interested, yet is less qualified, it is important that the plan does not simply dismiss the son and cause strife among the family
 - Successful business succession planning can eliminate or limit family conflict that could ultimately destroy the business
- < Contrary to the common belief among business owners, one can begin to transfer ownership interests when their children are young and still **retain control** over the business.
 - Because business owners often are more reactive than proactive, a team approach is often needed to move the owner to act.

Business Succession Planning Checklist

The following checklist is meant to facilitate a discussion between business partners on how to handle the succession of their business. Following this discussion, the partners would typically have an operating agreement or buy-sell agreement drafted to reflect their wishes. For those of you in solo practice, you should consider entering into a written agreement with another professional or family member who will take over your business upon your retirement or death.

1. What do you want to happen if one of you dies?

Whether the surviving shareholder/members will have the right to purchase the deceased shareholder/member's shares/interests; or, whether the company will be mandated to redeem said shares/interests; or whether the deceased shareholder/member's heirs will have the right to own the shares/interests. Do you want the deceased shareholder/member's beneficiaries to have the option to continue in the business? How

will the purchase or redemption of the deceased shareholder/member's shares/interests be funded? If life insurance is used, then who will own the life insurance and how will the buy-sell agreement be structured?

2. What if one of you becomes disabled?

Who manages the business in your absence? Do you want to protect the disabled shareholder/member's right to income? How do you want to handle the ownership of the disabled shareholder/member's shares/interests if the disability becomes permanent? How will the company fund the disabled shareholder/member's compensation? If disability insurance is used, then who will own the insurance policy and how will the buy-sell agreement be structured?

3. What if one of you wants to sell his shares/interests to a third party?

Do you want either the other shareholder/members or the company to have the right of first refusal?

4. How do you want to handle a dispute over the management of the business?

Do you want to be granted a "put" right, which will compel the company to purchase the shares/interests of one of you if a dispute over management arises and the partnership is no longer viable?

5. How do you want to handle giving an incentive to key employees for their continuing contribution to the success of the business?

Do you want to give an interest in the business to the key employees? Do you want to compensate a key employee for his/her contributions toward the growth and continuation of the businesses with shares/interests in the businesses, increased pay and/or a bonus incentive?

6. How do you want to provide for retirement or long-term care needs?

Do you want to sell shares/interest in the business to provide for retirement? Is there a qualified retirement plan, pension system or individual retirement account in place? Do you purchase Long-Term Care insurance?

All of the answers to these questions need to be addressed in a business succession plan and can be incorporated in an operating agreement and/or shareholder agreement.

Operating Agreements

An operating agreement is an agreement that regulates the affairs and conduct of a company and manages the relations amongst the members of the company. All the members of a Limited Liability Company may enter into an operating agreement pursuant to the Uniform Limited Liability Company Act.

- < An operating agreement is the fundamental document that governs a Limited Liability Company
- < Most states require LLC's to possess an operating agreement, but if no operating agreement is in place, the company is subject to the specific conditions as determined by the individual states
- < An LLC be used as a tool to supplement a business succession planning model. Members have the ability to designate who controls the company, who will be the successor, and the terms and conditions of succession to management and ownership. Further, operating agreements can detail the way in which ownership interests are transferred among owners and future owners.

Buy-Sell Agreements

A buy-sell agreement is an agreement between business owners to purchase and sell interests in the business at an agreed upon price in the event of certain future circumstances. These circumstances may include:

- Death
- Disability

- Incapacity
- Bankruptcy
- Termination of employment
- An offer from an outside party
- Retirement

A buy-sell agreement serves the interests of both the business entity and the owner's estate or family. It is:

- < Beneficial to the entity because it allows it to prohibit the sale of an ownership interest to unwanted parties, promotes a smooth transition between ownership, and avoids disputes amongst owners or family members
- < Invaluable to the owner because it ensures that one receives a fair price for one's ownership interest and that one's family receives a fair price if the owner passes away prematurely

There are several factors that should be considered when drafting a buy-sell agreement. These factors include the:

- Type, size, and value of the entity
- Value of the entity's assets
- Ages, financial condition, commitment, and health of the owners
- Family and working relationships among owners
- Applicable law and any other legal concerns

Types of Buy-Sell Agreements:

- < Cross-purchase agreement – requires or gives an option to remaining owners to purchase on a *pro rata* or other basis the ownership interest of the departing owner
- < Redemption agreement – the entity is required or has the option to purchase the ownership interest of the departing owner
- < Hybrid/Combination Agreement – the same as a redemption agreement, however, the entity is allowed to give its right to purchase the interest to the remaining owners
- < Funded LLC or "Life Cycle" Agreements

Different Purchase Pricing Options:

- Fixed price as agreed upon annually
- Book value or adjusted book value
- Appraised value
- Capitalization, or a multiple of earnings formula

Book value and multiple of earnings are susceptible to manipulation, when one may no longer be around to protect one's family. Appraisal and agreed upon annually will generally aid in reducing potential for conflict when a purchase is mandated.

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:

- Installment sale based on the current earnings of the business
- A sinking fund whereby a certain amount of funds from the business are invested to provide for a future purchase
- Cash from borrowings at the date of purchase
- Life insurance

The life insurance method is typically the safest method. The other methods depend upon the financial solvency of the business or the other owners at the time that a purchase is required.

While buy-sell agreements are useful in most situations, they may not be the only or most effective way – mostly for tax purposes – to transfer ownership interest to the withdrawing or deceased owner. Some of the other methods to consider are:

- Recapitalization
- Compensation-based plans
- Defined benefits plans
- ESOPs

Partnerships, S Corporations and LLCs are the standard types of organizations for most family-owned businesses. Because they are not taxable entities themselves, the tax considerations are unique. These considerations include:

- Compliance with partnership or LLC rules
- Any gain or loss by the departing owner or by the owner's family
- The effect the sale would have on the taxable year of the departing owner and the remaining owners
- How the sale would be characterized as ordinary income for the departing owner

Other Critical Aspects of Your Business Planning

It is important to have other issues addressed as they relate to remaining profitable in running your business. You should have a valuation of your business assets/entity. Furthermore, having quality advisors such as an accountant and financial planner are necessary aspects of your fiscal affairs. Certain insurance products, like liability, life, disability and long-term care insurance, can help manage risks and provide liquidity during critical times. Lastly, incorporating a system to manage and coordinate all your financial and legal "moving parts" is critical – as well as to ensure a regular, ongoing review process. The long term success of your business plan is dependent on (1) regular review and fine tuning of your company's governing documents, (2) consistent documentation of company actions and (3) timely state and federal filings to help keep pace with the myriad legal requirements of operating a business.

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Conclusion

Beyond running one's personal and business affairs is the looming issue of how to pass your assets on to your successors. This requires careful consideration of many issues, including family security, estate, capital gains and income taxation, asset protection, and prudent business planning. To that end, there are a host of legal structures available to help govern your affairs both during your lifetime and after death: Power of Attorney, Health Care Proxy, Disposition of Remains Appointment, Will, Revocable Living Trust, or LLC. Naturally, there are many other types of trusts and various legal strategies to help you plan your and your family's future, in addition to continuing or divesting your business enterprise. Contact McDermott, Pierro, Mandery & Mandery to discuss how to best protect you, your family and the business through comprehensive Business Succession & Estate Planning. We look forward to being part of your advisory team!

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