Family Business Succession Planning Opportunities

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Abstract
Family businesses account for over 50% of U.S. GDP, and 35% of Fortune 500 companies are controlled by families. These companies are vital to the economy, offering stability, a long-term commitment, and responsibility to their communities and employees. Although family-owned businesses are responsible for 60% of jobs in America, a recent family business survey done by the National Bureau of Economic Research’s Family Business Alliance indicates that despite succession being a critical issue for many family companies, only 15% of them have anything resembling a succession plan in place. Furthermore, businesses have a difficult time surviving through multiple generations; just making it to the second generation is a milestone event; only 30% make it through the second generation, and just 12% make it through the third (“The Family Business Sector in 2016: Success and Succession,” PricewaterhouseCoopers, https://pwc.to/2D3ftcF).

This article explains how CPAs, as trusted advisors, can play a significant role in establishing prudent and functional succession plans for their business owner clients.

Disciplines
Business

Comments
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Family Business Succession Planning Opportunities

By Savas Saymaz and Hugh H. Lambert

Any family business, however successful, will reach a day when ownership must change hands. A plan of succession for ownership of business interests ensures that the business will continue to operate with a minimum of disruption and can also provide tax benefits to the owner and the successor. The authors detail the various options available to business owners looking to establish succession plans, noting where CPAs can leverage their position as trusted advisors to assist clients with establishing such plans.

What Is Succession Planning?
Succession planning is the process of developing a written plan for an occasion when an owner decides, or is forced, to step down from an ownership and leadership role in the business. This event can be voluntary, such as retirement, or involuntary, such as death or incapacitation. Closely held family businesses do not have the same depth of management that large corporations enjoy. Good succession planning in these cases involves both determining who will own shares of the corporation and who will take on the leadership roles. Who does the owner want to have an ownership stake in the company, and how will that ownership ultimately change hands? All business owners will exit their businesses at some point, either by design or by default, and a succession plan helps ensure that owners have control over how their businesses transfer to the next owners. Needless to say, a succession plan must be documented and communicated to all parties who may be affected by it.

CPAs as Trusted Financial Advisors
There are approximately 30.2 million small businesses in the United States employing 47.5% of the workforce, or nearly 60 million people (U.S. Small Business Administration, 2018 Small Business Profile, http://bit.ly/2rkTKdI). There is plenty of opportunity for CPAs to take the lead in succession planning for these companies, as many baby boomers (i.e., those born between 1946 and 1964) who own small to midsize enterprises (SME) will need to exit their businesses either voluntarily or involuntarily in the coming years. The baby boomers will be the wealthiest generation until 2030, and even then, nearly 60 million will still be alive, controlling 70% of disposable income. Cerulli Associates estimates that, over the next 25 years, $68 trillion of spousal or intergenerational wealth will be transferred from boomer business owners, and their successors will continue to need trusted advisors on tax and suc-

Business owners spend the majority of their time working in their businesses instead of on their businesses, as evidenced by the fact that as many as 68% of owners consider exit planning a low priority compared to other business-related needs (BEI 2016 Business Owner Survey Report, Business Enterprise Institute, http://bit.ly/344diRP). When asked why they don’t have succession plans, respondents to a survey by the Family Business Institute (FBI) said that “time to deal with the issue” was a significant constraint. Other reasons included feeling it was too early to plan for succession, inability to find adequate advice or tools to start, finding the topic too complex, not wanting to think about leaving the business, and fear of conflict with family or employees (FBI 2016 Business Owner Survey).

The AICPA supports succession planning by offering specialty credentials, including Personal Financial Specialist (PFS) and Accredited in Business Valuation (ABV), along with national conferences focused on valuation, succession, and wealth transfer issues. Traditional services offered by CPAs, including financial statement attestation services and tax planning, are complementary to succession planning.

Current Transfer Tax Law

Before discussing succession plan options, a review of current transfer taxes is in order. Under the provisions of the American Taxpayer Relief Act (ATRA) of 2013 and the Tax Cuts and Jobs Act of 2017 (TCJA), the annual gift tax exclusion for 2019 is $15,000 indexed, the top gift and estate tax rate is 40%, and the lifetime gift, estate, and generation-skipping exemption, indexed for inflation, is estimated to be $11.4 million. Portability between married couples is permanent and allows couples to share their exemptions. Any unused portion of the first spouse’s estate tax exemption can be added to the surviving spouse’s estate tax exemption.

The following sections discuss various options for succession planning in light of current transfer tax law, which are summarized in Exhibit 1.
Outright Gifts

Some succession plans involve the gift- ing, rather than the sale, of a business inter est. This situation favors taxpayers who have accumulated sufficient wealth during their lifetime that they do not need the pro ceeds from selling their interest in a com pany. In such cases, the goal of the tax payer, typically the senior owner, is to pass the business on to adult children so that it can remain in the family.

An outright gift is the least complex but most inefficient way to transfer wealth. A small annual gift ($15,000 for individuals in 2019, $30,000 for married couples) can be made to multiple parties without affec ting lifetime exclusions (the dollar value transferrable during life or at death without paying transfer taxes, as will be discussed below). Any businesses with significant value would, however, take years to give away. Fortunately, taxpayers can also use their lifetime exclusions (i.e., the amount of wealth that can be given away tax free during life). In 2019, this amount is $11.4 million per taxpayer or $22.8 million for a married couple; thus, a $1.5 million business could be gifted by an individual with no gift tax due. For businesses with values in excess of the lifetime exclusion amount, other wealth transfer strategies and vehicles may become part of the succession plan in order to transfer those assets in a more tax-efficient manner.

For privately held companies, transfers of minority interest (i.e., less than 50% interest in a business) are the most tax efficient way to make gifts of shares. This is because minority equity interests (also called noncontrolling interests) are worth less than controlling interests in the same company and thus subject to a lack-of-control discount. Noncontrolling interests also lack the immediate liquidity of equity interests in publicly traded companies. As such, interests in privately held businesses are also subject to a lack of marketability discount. In contrast, instances in which a business owner transfers or dies holding a controlling interest are tax inefficient.

### Exhibit 1
Succession Planning Strategies

<table>
<thead>
<tr>
<th>Concept</th>
<th>Taxation</th>
<th>Advantages</th>
<th>Disadvantages</th>
<th>When most suitable</th>
</tr>
</thead>
<tbody>
<tr>
<td>Outright gift</td>
<td>No tax (under exemption)</td>
<td>Easy</td>
<td>Give up control&lt;br&gt;Give up income&lt;br&gt;Only income growth is out of estate</td>
<td>Current value of business is less than applicable exclusion amount</td>
</tr>
<tr>
<td>Recapitalization into voting/nonvoting stock</td>
<td>No tax (under exemption)</td>
<td>Maintain some level of control</td>
<td></td>
<td>Younger generation not yet ready to take over</td>
</tr>
<tr>
<td>Grantor retained annuity trust</td>
<td>Minimal-to-zero gift tax</td>
<td>Receive income for term&lt;br&gt;Reduced gift value&lt;br&gt;Income out of estate if grantor dies within term of GRAT</td>
<td>Income included in estate if grantor dies within term of GRAT</td>
<td>Companies with highly appreciable assets</td>
</tr>
<tr>
<td>Bequest</td>
<td>Estate tax on fair market value</td>
<td>Retain control during lifetime</td>
<td>Estate tax applicable&lt;br&gt;Full appreciated value in estate</td>
<td>Companies where the owners rely on income from the business</td>
</tr>
<tr>
<td>Installment sale/SCIN</td>
<td>Tax on gain and interest</td>
<td>Income stream</td>
<td>After-tax income&lt;br&gt;Payments/balance in seller’s estate (unless SCIN)&lt;br&gt;SCIN requires higher payments</td>
<td>Owner wants to retain control&lt;br&gt;Discount on stock sold&lt;br&gt;Freeze value of stock at date of sale</td>
</tr>
<tr>
<td>Buy-sell agreement</td>
<td>Step-up in basis&lt;br&gt;No capital gain at death&lt;br&gt;Estate inclusion</td>
<td>Retain control&lt;br&gt;Retain income&lt;br&gt;Funded with life insurance</td>
<td>Ability to purchase insurance&lt;br&gt;Full fair market value</td>
<td>Works best in entities with multiple owners</td>
</tr>
<tr>
<td>ESOP</td>
<td>Can provide tax advantages</td>
<td>Good option when no family successors</td>
<td>Expensive, complicated to set up and administer</td>
<td>Company does not have clear family member successor</td>
</tr>
</tbody>
</table>

ESOP=Employee Stock Ownership Plan<br>GRAT=Grantor Retained Annuity Trust<br>SCIN=Self-Cancelled Installment Note
Family Limited Partnerships and Limited Liability Companies

Family limited partnerships (FLP) and family limited liability companies (FLLC) provide a way for families to consolidate assets for more efficient management, obtain creditor protection, and facilitate transfers of multiple assets classes within a single entity. FLPs and FLLCs are entities in which assets such as marketable securities, real estate, and equity interest in privately held companies can be placed. These entities are governed by partnership or LLC agreements that spell out the way that the entities will be governed, including management and distribution policies, transfer restrictions, and dissolution. FLPs and FLLCs offer asset protection in the event creditors attempt to reach the underlying assets that have been contributed to the entities, which form a protective “wrapper” around those assets. Creditors cannot force the FLP or FLLC to sell assets.

Using FLPs and FLLCs is another way for the senior generation to transfer assets to the successor generation while maintaining control by maintaining the general partnership interests in an FLP or being named the managing member of a managed FLLC. Families must remember to respect and formally adhere to the governance provisions of partnership or limited liability agreements. Wealth transfers can be made via gifts of the FLP or FLLC interests, which may also be discounted for their lack of control and lack of marketability.

Equity Recapitalizations

One issue faced by business owners is a fear of losing control of the company once transfers have been made to the successor generation. Recapitalizations of equity can allow business owners to transfer a large economic interest in the business while maintaining control; this is accomplished through recapitalizing the company’s equity into voting and nonvoting equity interests and then transferring the nonvoting interests to the next generation. By maintaining voting power, the senior generation can maintain control over how the business is governed while transferring the majority of the business value to the next generation via the nonvoting stock. The transfer can be accomplished via a sale (if the business owner wants compensation for the ownership interest) or by gift (if the business owner wishes to minimize estate taxes upon death). The recipients of the nonvoting stock will share in dividends and capital appreciation of their equity interests.

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Grantor Retained Annuity Trusts

A Grantor Retained Annuity Trust (GRAT) is a special trust vehicle funded with assets by the trust’s creator (or grantor). The beneficiary of this trust is the party that will receive the trust assets at the end of the GRAT’s stated term, which is finite and defined by the grantor at the time of the GRAT’s creation. GRATs work as follows: 1) the grantor funds the GRAT with assets; 2) the grantor is paid an annuity from the income generated by the GRAT’s assets (or is paid in kind, if the asset in the GRAT does not generate cash flow); 3) at the end of the GRAT’s term, any remaining assets pass to the beneficiary.

GRATs can be a more gift tax–efficient way to pass assets to beneficiaries because the amount of the gift made by the grantor is the value of the assets contributed to the GRAT minus the present value of the annuity. Suppose that a taxpayer contributes $1 million to a GRAT and takes back an annuity with a present value of $300,000. The taxpayer has transferred $1 million, but the amount of the gift is considered to be $700,000. In some strategies, the present value of the annuity is set at the same amount as the value of the asset with which the GRAT was funded. In the above example, the taxpayer could fund the GRAT with a $1 million asset and take back an annuity with a present value of $1 million, and no gift tax would be due.

The type of assets placed into the GRAT must be selected with care. Assets with above-average potential for appreciation make good candidates, as one of the benefits of GRATs is that the gift tax due (if any) is paid at the time the GRAT is funded, and not when the remaining GRAT assets transfer to the beneficiaries at the end of the GRAT’s term. Thus, high-appreciating assets can pass to the beneficiaries of the GRAT tax free. These appreciated assets will come out of the grantor’s net worth, an important aspect of planning for wealth preservation for high-net-worth families.

Bequests

Alternatively, a business owner could simply transfer the business to the successor generation at death. (The successor will receive a step-up in basis to date of death value.) The advantage of retaining the business until death is that the owner retains full control of and income from the business.

Installment Sales

Instead of gifting the business interest to a successor, the owner can sell some or all of the business to the successor or to an intentionally defective trust. In this option, the owner would transfer the inter-
they were partners, 35.6% were managers, 14.1% were senior accountants, and 20.4% were staff accountants. Thus, survey respondents were relatively experienced accounting professionals. Exhibit 1 provides a detailed description of the demographics of survey respondents.

The survey was a handout containing 17 questions; 11 questions pertained to practitioners’ sentiments on current and proposed pathways to becoming a licensed CPA, while 6 questions pertained to practitioners’ demographics. Practitioners answered the pathways questions by using a 1- to-5 point scale, ranging from completely disagree (1) to completely agree (5).

Survey Results

Should it be possible to become a CPA without passing all four of the competencies currently tested on the CPA exam? Practitioners expressed very strong support for keeping the four competencies currently tested on the CPA exam; practitioners did not, however, agree that it should be possible to obtain the CPA credential without passing all four of those competencies currently tested. The average practitioner response on this question was 1.71. Exhibit 2 illustrates these results.

Should specific, individual competencies be removed from the CPA exam? Practitioners were asked to indicate individually whether they supported removing each currently tested competency from the CPA exam. Practitioners objected most strongly to removing FIN, though relatively similar levels of resistance were found for removing each competency, as illustrated in Exhibit 3. Of particular interest, practitioners on average disagreed with the idea that any of the four competencies currently tested on the CPA exam should be removed.

Does practice area affect an individual’s opinion? To determine whether respondents’ practice area affected their opinions, the authors analyzed practitioners’
The IRS’s website notes that:
An employee stock ownership plan is an IRC [Internal Revenue Code] section 401(a) qualified defined contribution plan that is a stock bonus plan or a stock bonus/money purchase plan. An ESOP must be designed to invest primarily in qualifying employer securities as defined by IRC section 4975(e)(8) and meet certain requirements of the Code and regulations. The IRS and Department of Labor share jurisdiction over some ESOP features (http://bit.ly/35lpG9Y).

ESOPs are a good succession planning strategy when a privately held company does not have a clear family member successor or a management group to purchase the company. The shares are valued prior to the sale to the ESOP and every year thereafter, so the employees know the value of their investment in the company.

ESOPs can be a win-win situation for business owners looking for a tax-efficient succession plan, as well as for employees, who can share in the upside of the company’s appreciation.

State-Specific Considerations

State estate tax–specific discussions may apply in light of the temporarily expanded federal exemptions under the TCJA. For example, New York imposes a state estate tax as high as 16% of the New York–taxable estate; the expanded federal exemptions thus give New Yorkers greater opportunities to plan proactively to reduce their New York taxable estates.

New York’s estate tax law has a “cliff” built into its estate tax calculation, which quickly phases out the benefits of the New York basic exclusion amount (currently $5,740,000). If the amount of the taxable estate is more than 5% of the exclusion amount at death, the individual cannot take advantage of New York’s exclusion; these estates are subject to New York estate tax in their entirety. In other words, if an individual who resides in New York dies in 2019 with a taxable estate of $6,200,000, then the entire estate is subject to New York estate tax.

In contrast to the federal estate tax exemption, the New York estate tax exemption is not portable to spouses for lifetime gifting. Therefore, to preserve the exclusion amount of the first spouse to die, wills can direct that an amount equal to the spouse’s New York exclusion pass to a credit shelter (or bypass) trust. The assets in the trust would escape state taxation at the deaths of both spouses. For example, assume a New York couple has a $9,000,000 estate at the time of the first spouse’s death in 2018. Due to the unlimited marital deduction, there was no fed-

ERAL OR STATE TAX AT THE DEATH OF THE FIRST SPOUSE. IF THE SECOND SPOUSE DIES IN 2019, THE ENTIRE ESTATE WILL BE SUBJECT TO STATE ESTATE TAX SINCE THE APPLICABLE NEW YORK EXCLUSION AMOUNT IS ONLY $5,740,000. THIS COULD BE AVOIDED, HOWEVER, IF THE FIRST SPOUSE’S WILL DIRECTED THAT A CREDIT SHELTER TRUST BE FUNDING AT THAT SPOUSE’S DEATH, WITH THE 2018 STATE EXCLUSION AMOUNT OF $5,250,000 AND THE REMAINDER PASSING OUTRIGHT TO THE SURVIVING SPOUSE. THE STATE EXCLUSION AMOUNT WOULD THEN BE AVAILABLE TO SHIELD THE TAXABLE ASSETS REMAINING OUTSIDE OF THE CREDIT SHELTER TRUST.

In addition, New Yorkers may consider lifetime gifting and charitable gifts in their wills, as well as implementing certain trusts in order to avoid the estate tax cliff. These strategies can reduce the taxable estate for those slightly above exclusion amount. Keep in mind, however, that certain gifts made within three years of death will be added back and subject to estate tax.

As a result of the significant spread between the federal and New York estate tax exemptions ($11,400,000 and $5,740,000, respectively), individuals who die in 2019 with estates below the federal estate tax exemption amount may still owe substantial New York estate tax if their estates exceed the New York estate tax exemption amount. New York residents should consult with their financial advisor to manage their exposure to the estate tax cliff.

A Case for the Trusted Advisor

CPAs are in a unique position to work on succession planning issues, as they often have long-term relationships with business owners and their families, understand the business, and have knowledge of the company’s financial position. Any succession plan will involve a team: lawyers, financial planners, appraisers, insurance experts, and accountants. Given the magnitude of the business successions that will occur as the baby boomers retire, CPAs will have ample opportunities to assist business owners, so that their business will survive and the legacies that they have created will benefit future generations.

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