SUCCESSION PLANNING FOR THE NEXT GENERATION

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Basic Life Cycle of a Business

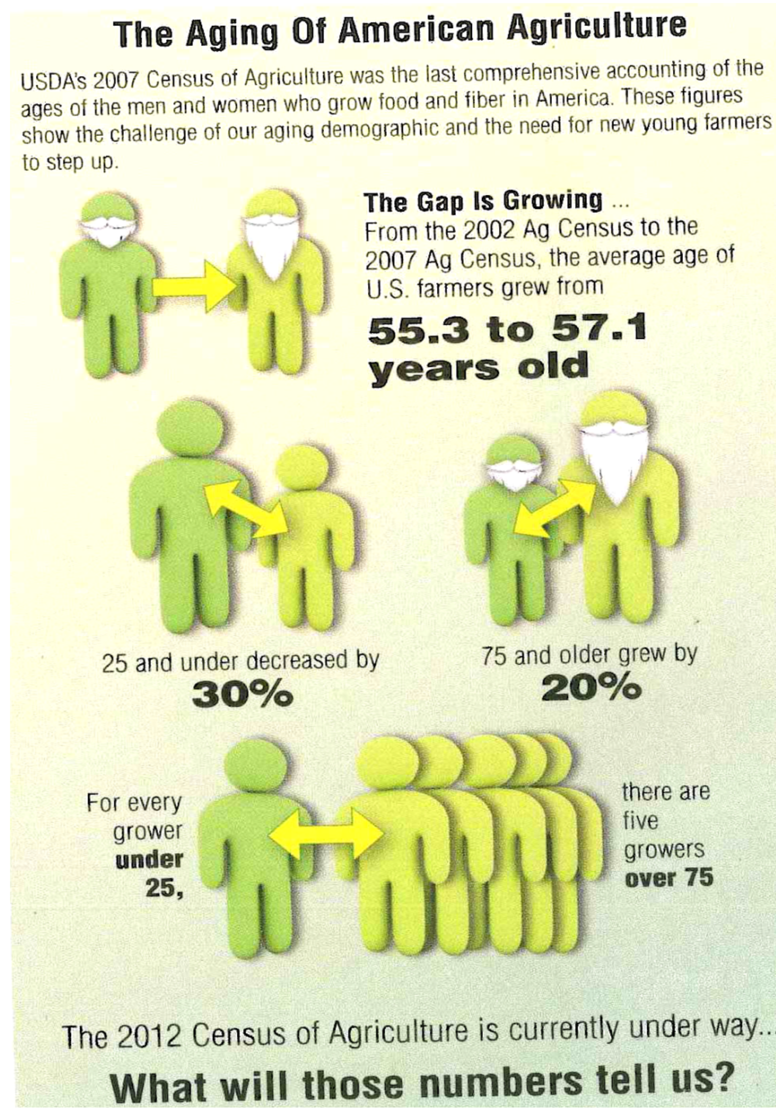
- Start-up
- Expansion/Growth
- Financial Stability
- Transition of Management, Control and Ownership
  - During Principal's lifetime
  - Upon Principal's Retirement
  - At Principal's Death
- Continuation under new ownership vs. sale

What is “Succession Planning”?

- Planning for the transition of management, control and ownership to successors to promote the continuity and future success of the business
- Involves much more than an estate plan
  - Identification and development of the next leaders
  - Governance structure
  - Business structure
  - Family governance
  - Financial planning

Why is Succession Planning Important?

- Surveys indicate less than 1/3 of family businesses survive to the 2nd generation and less than half of those survive to the 3d generation.
- According to the *Farm Journal,* 80% of ag owners planned to transfer ownership to the next generation, but less than 20% felt confident their existing plan will work
- According to a USDA study, an estimated 70% of U.S. farm land will be transferred in the next 20 years



* Source: Florida Grower (May 2013)

Issues for Transition of Management, Ownership and Control

(ownership does not necessarily equal control)

- Minimizing income and transfer taxes
  - Transferring appreciation and income during life
  - Generating liquidity to pay estate tax and preserve business
- Preserving ownership and control from interference of outside parties
  - Examples: creditors, divorce, in-laws, friends/unrelated business partners
- Maintaining financial security and cash flow for principal(s) after retirement
- Structuring management
  - Selecting successors
  - Incorporating outside advisors
  - Communicating to next generation

Issues for Transition of Management, Ownership and Control
(cont.)

- Treating family members equitably
  - Equitable treatment does not always mean equal treatment
  - Members working in the business vs. members not working in the business
  - Managing expectations
- Managing family conflicts
  - Members wanting to “cash out” vs. members wanting to continue the business
  - Incorporating third party advisors
- Maintaining flexibility for future circumstances
  - Incorporating new investments
  - Protecting sale proceeds

Overview of Income Tax Rules

- During lifetime
  - Top income tax rate of 39.6% for salary or trade or business income
  - Top capital gains rate of 20% on sale of capital assets held for > 1 year
  - Surtaxes are imposed on net investment income
  - State income tax may apply to non-Florida resident owners
  - No income tax imposed on either donor or donee on gifts
    - Donee takes a “carryover basis” , which defers income tax
    - Income tax can be deferred on a sale depending on the identity of the purchaser and the seller’s tax basis in the asset being sold
      - Example: Sale to a trust which qualifies as a “grantor trust” is not a taxable sale for income tax purposes.
- At death
  - No income tax generally due for transfers at death
  - Recipient generally receives a tax basis for income tax purposes equal to the date of death value of the asset. If the asset had built-in appreciation at death, then that appreciation will pass to the benefit of the heir free of income tax.

Overview of Transfer Tax Rules

- Exemptions & Rates
  - $5 million cumulative exemption per person for transfers during life and at death, indexed for inflation ($5,250,000 in 2013)
  - 40% transfer tax rate for transfers in excess of exemption
- Lifetime transfers
  - Gift tax & Generation-Skipping Transfer (GST) tax
  - Married couples can split gifts made by one spouse
  - Annual exclusion gifts ($14,000 per donee in 2013) are not counted towards $5+ million exemption
  - Tax due by April 15th of the calendar year following the gift
- Transfers upon death
  - Estate tax & GST tax
  - Can now use deceased spouse's unused estate tax exemption
  - Tax generally due 9 months after death

FACT PATTERN: Ag Co, LLC

Owner
Dad

100%

Ag Co, LLC

Assets	**Key Employees**
Trucks/Equipment ($700k)	Dad
Cattle ($300K)	Third Party (TP)
Citrus Groves ($3m)	Daughter 1
Real Estate ($10m)	Son

Family Members

*Daughter 1 (2 kids)

Daughter 2 (1 kid)

*Son (no kids)

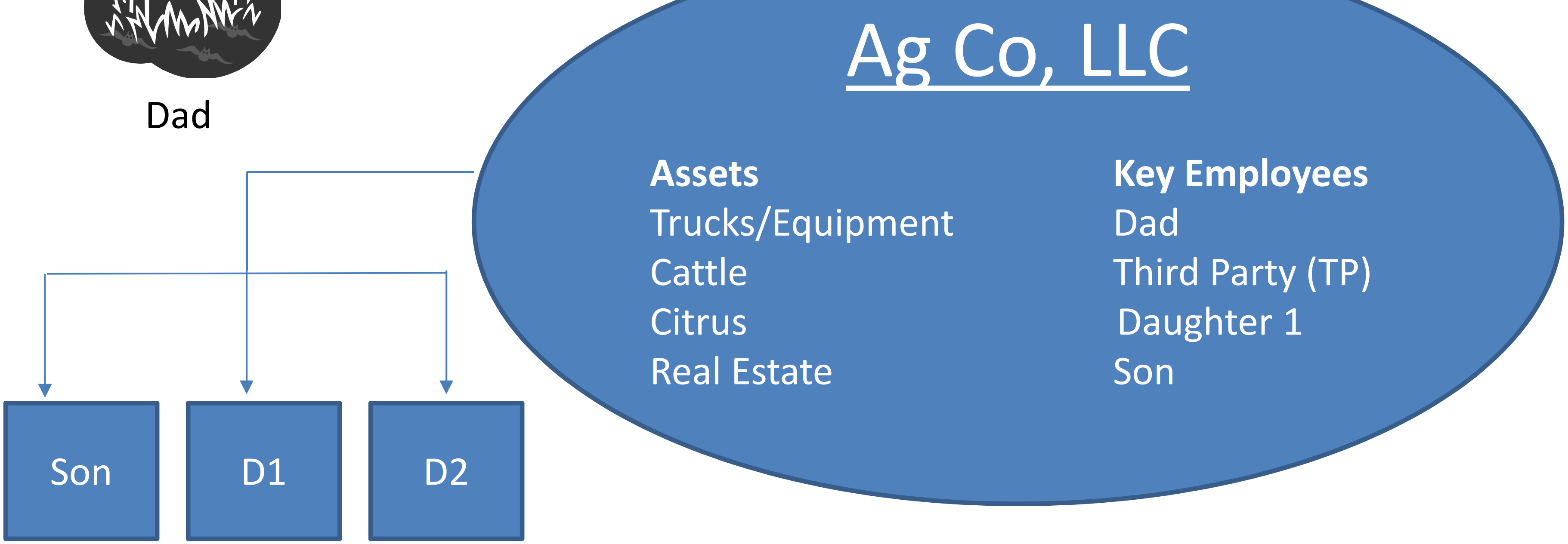
* = Works in Ag Co.

Assume:

1. Dad is 50 years old;
2. Ag Co. is worth $14m; Dad's remaining assets are $1m
3. Dad's Will divides all assets equally among children
4. Daughter 2 has financial problems
5. Son and TP do not "get along"

Scenario #1 – Dad dies unexpectedly at age 55

Dad



<u>Issues:</u>

1. Interests acquired by children can be reached by their creditors (possibly including former spouses in a divorce)
2. D2, who is not in the business, acquires a 1/3 voting interest, which means she is a swing vote.
3. Children are left to create governance structure without input *and influence* from Dad
4. TP, who was Dad's key manager, could be eliminated
5. Dad pays estate tax on 100% of business. No discounts are available
6. How will the estate tax be paid?

Reducing the Estate Tax

- Qualify for 2032A special use valuation
  - Property must generally be valued at its highest and best use for estate tax purposes
  - 2032A permits qualifying real property (QRP) used in a family farm or closely-held business to be valued at its "current use" instead of its "highest and best use"
  - Aggregate reduction in the fair market value of the QRP from its highest and best use cannot exceed $1,070,000 (adjusted for inflation after 2013)
    - **Estate tax savings in 2013 = 40% x $1,070,000 = <u>$428,000</u>**
  - This reduction is taken against FMV of the property after considering other applicable valuation discounts

Reducing the Estate Tax
(cont.)

- Qualifications for 2032A special use valuation
  - Decedent is a U.S. resident or citizen and property is located in the U.S.
  - Property must be devoted to a farm or farming purposes or in a trade or business
  - QRP must pass to a “qualified heir” (i.e., spouse; ancestor; lineal descendants of decedent, decedent’s spouse or decedent’s parents; spouse of any such lineal descendant)
  - Decedent or family member must have owned the property and materially participated in the business for 5 of the 8 years preceding death
  - Value of <u>real and personal</u> property used in the business must be at least 50% of the adjusted value of the gross estate
  - Value of the <u>real</u> property used in the business must be at least 25% of the adjusted value of the gross estate
  - QRP designated in written agreement consents to recapture tax.

Reducing the Estate Tax
(cont.)

- 2032A special use valuation recapture tax
  - Some or all of the tax benefits may be "recaptured" if the QRP is transferred outside the family or ceases to be used as a farm or closely held business during the 10 year period following the decedent's death
  - Recapture tax is generally equal to the tax that would have been due had §2032A not been elected
  - Tax is due 6 months after qualified use ends
  - Qualified heir is personally liable for recapture tax
- IRS will have a lien on a portion of the QRP in an amount equal to the tax savings, unless IRS accepts other security

Paying the Estate Tax

- Options
  - Use nonbusiness assets
  - Sell off business or business assets
  - Borrow from third party lender
- Better options
  - Use life insurance proceeds
    - Insurance held by the owner at death and/or payable to the owner's estate will be subject to estate tax, but insurance owned by a trust can be excluded from the estate tax
    - Set up an irrevocable life insurance trust (ILIT) to own policy on Dad's life. At death, the proceeds will be paid to the ILIT free of estate tax. The ILIT can loan the proceeds to the estate or purchase assets from the estate
  - Qualify for Code 6166 extension of time to pay estate tax

Paying the Estate Tax
(cont.)

- Qualify to extend tax payments over a period of up to 15 years after death (Code § 6166)
  - Estate can pay interest only for the first 4 years on unpaid tax attributable to a closely held business interest and then pay principal and interest from years 5 through 14.
  - Without § 6166, the full estate tax is generally due 9 months after date of death. Extensions for reasonable cause are at the discretion of the IRS

Paying the Estate Tax
(cont.)

- Qualifications for 6166 extension
  - Decedent must be a U.S. resident
  - Value of decedent's interest in a closely held business exceeds 35% of adjusted gross estate
- "Interest in closely held business" includes:
  - Interest in a trade or business carried on as a proprietorship
  - Interest in a partnership carrying on a trade or business if the partnership has 45 or fewer partners, or at least 20% of total capital interest is included in the decedent's gross estate
  - Interest in a corporation carrying on a trade or business if the corporation has 45 or fewer shareholders or at least 20% of the voting stock is included in the decedent's gross estate
- 20% ownership requirements can be met through direct and indirect ownership
- Interests in 2 or more closely held businesses can be aggregated for purposes of satisfying 35% test if the decedent owns 20% or more of the total value of each business
- If a §6166 election is made, the IRS will place a lien on §6166 property sufficient to cover the deferred tax and interest

Paying the Estate Tax
(cont.)

- 6166 election will terminate and the deferred estate tax will be accelerated upon the occurrence of any of the following:
  - A disposition of any portion of the closely held business interest or a withdrawal of money or property from the business, which, in the aggregate, equals or exceeds 50% of the value of the decedent's closely held business interest
  - Failure to timely pay interest or principal
- Interest Rate on installments:
  - 2% on the tax on the first $1,000,000 (adjusted for inflation) of assets (using the highest marginal rate)
  - 45% of the current underpayment rate for the excess. Current underpayment rate is 3%; 45% of that is 1.35%
- Even if the business is liquid, 6166 gives the business the opportunity to take a very cheap loan from the IRS

Dad’s Final Estate Tax Bill

- Estate tax on $15m gross estate = $3.9m due 9 months after death!
- However, gross estate can be reduced by $1.07m to $13.93m because of 2032A election
  - Estate tax on $13.93m = $3,472,000
- Moreover, payment of tax can be deferred under 6166
  - Non-deferred tax = $231,500 due 9 months after death
  - 6166 deferred tax = $3,240,500
  - Interest payments for 2015 -2028 = $47,800 / year
  - Installments for 2019 – 2028 = $324,000 / year

Scenario #2: Dad survives and does some planning – Ag Co. Before

Owner
Dad

100%

Ag Co, LLC

Assets
Trucks/Equipment
Cattle;
Citrus
Real Estate

Key Employees
Dad
Third Party (TP)
Daughter 1
Son

Family Members

*Daughter 1 (2 kids)

Daughter 2 (1 kid)

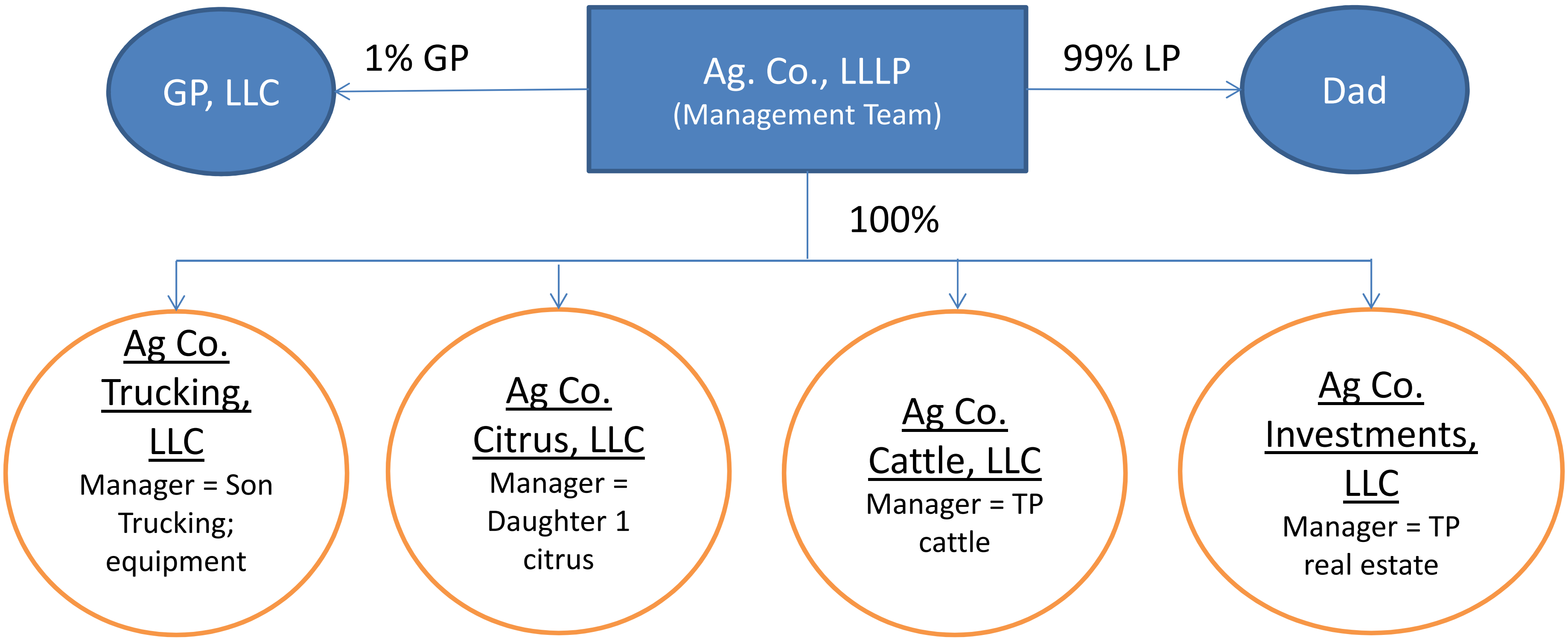
*Son (no kids)

* = Works in Ag Co.

Goals of Restructuring

- Set up framework for all future planning
- Establish management, ownership and control structure that will survive Dad and communicate the plan to the next generation
- Create mechanism to transfer growth during Dad's life to lower generation(s) to reduce estate tax
- Isolate operational liabilities
- Protect business operations from future outside creditors of Dad and children

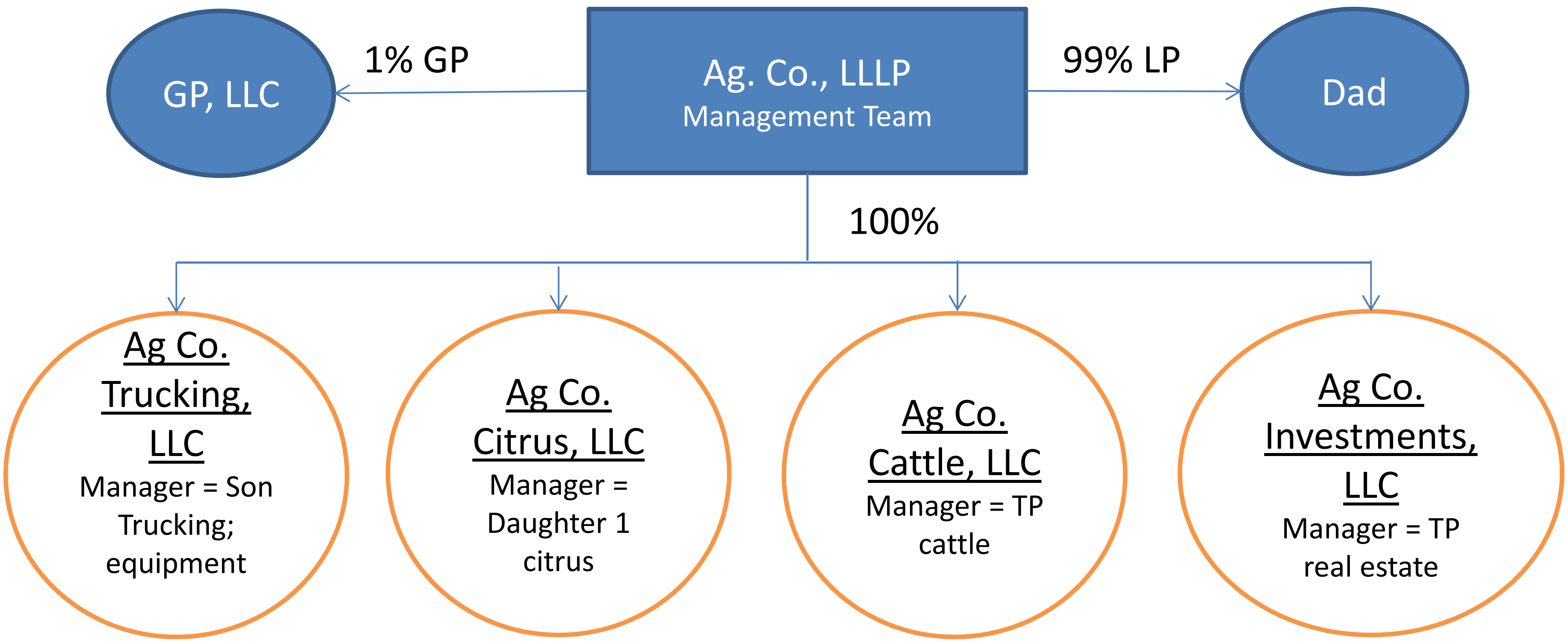
Scenario #2: Dad survives and does some planning – Ag Co. After



Benefits

1. Liabilities from each line of business are isolated
2. Ownership cannot be acquired by outside creditors
3. Voting control isolated in GP, LLC
4. Management team of LLLP oversees all business lines
5. Individual managers of each sub-LLC manage individual business lines
6. LP interests allow for transfer now of future growth and income

Scenario #3 – Dad makes transfers during life (Pre-Gifts)



Making Lifetime Gifts to Reduce the Estate Tax

- Future growth and income is accumulated in donee's estate, not donor's estate
- Valuation discounts are available for transfers of entity interests
  - Minority interests; lack of marketability
  - Discounts can be substantial (30%+)
- No tax due at the time of the gifts if the value of the gifts are less than Donor's lifetime exemption
- Remember: Transferring ownership does not necessarily mean transferring control

Making Lifetime Gifts to Reduce the Estate Tax (cont.)

- EXAMPLE: Ag Co. is worth $14 million in 2013 and Dad has $1 million of other assets. Assume Ag Co. grows 50% to $21 million and Dad's other assets grow to $1.5m million by his death in 2020.
  - ***Without restructuring & lifetime gifts:*** Dad's estate tax is projected to be $22.5m - $6.5m (projected inflation-adjusted exemption in 2020) x 40% = $6.4m.
  - ***With*** **restructuring** ***and a gift in 2013:*** Assuming a 35% discount is applicable, Dad could transfer a 19.23% LP interest for the benefit of each of his children (total = 57.7% LP) to use his $5.25m exemption. At death, Dad's estate tax would be calculated as follows:

    $1,500,000 other assets

    +$5,637,450 for 41.3% LP interest (assuming 35% discount)

    <u>+$105,000 for interest in GP, LLC (assuming 50% interest in GP, LLC and no discounts)</u>

    $7,242,450 Gross Estate

    <u>- $1,500,000 remaining exemption ($1.5m COI adjusted exemption in 2020)</u>

    $5,742,450 taxable estate

    <u>X 40% estate tax rate</u>

    $2,296,980 estate tax

Making Lifetime Gifts to Reduce the Estate Tax (cont.)

	Without Lifetime Gifts	With Lifetime Gifts
Estate Tax	$6,400,000	$2,296,980
Net Amount passing to heirs	$16,100,000	$20,203,020

Total tax savings = $4,103,020

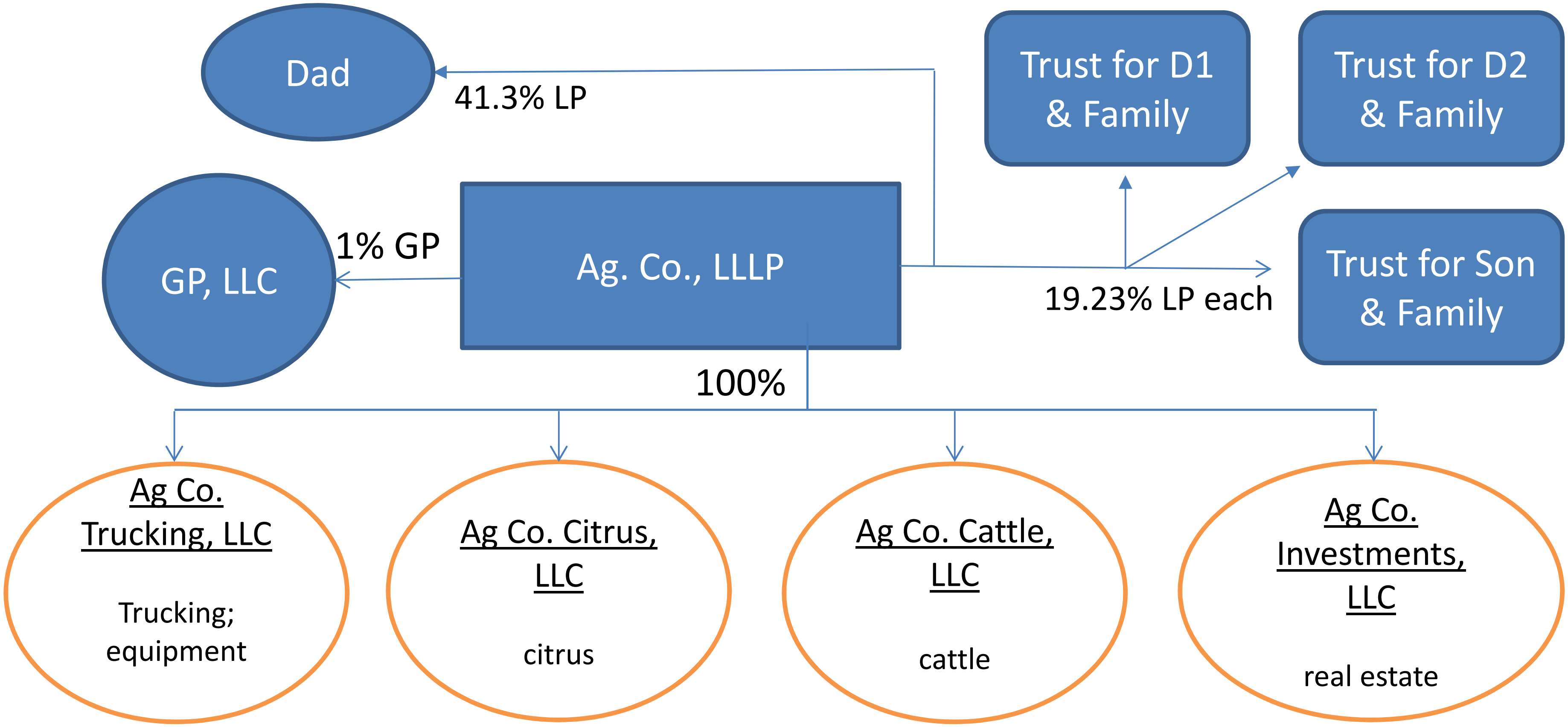
Equitable (not equal) treatment of family members

- One of the most difficult issues to deal with is how to handle those working in the business vs. those not working (and often, not interested) in the business
- Possible solutions
  - Employment agreement with bonuses/retirement contributions to reward those working in the business
  - Unequal ownership
    - Business ownership can pass to selected beneficiaries while others receive non-business assets of equivalent value, such as life insurance proceeds
    - Divide into voting and non-voting interests so that control is transferred to those involved in the business
  - Buy-out agreement which fixes method for establishing value and payment terms
  - Fixed value interests can be given to family members who are not active in the business to provide a consistent return and shift the benefit of growth to the active members

Who should receive the gifts?

	Individual	Trust
Management of interest	Individual Owner	• Professional and/or other trustworthy fiduciary. • Can be relative or beneficiary
Transfer at death	Potentially subject to probate.	Avoids probate
Creditor protection	Available to creditors of individual	Generally protected while in trust
Divorce protection	Ripe for litigation (valuation is always an issue); Prenup is a must	Generally protected while in trust
Subject to future transfer tax	• Estate tax at owner's death • Gift tax if transferred to another • GST tax if transferred to a grandchild or lower generation	• Can be exempt from estate, gift and GST tax for up to 360 years while in trust • Distributions permitted to multiple persons without tax
Flexibility if circumstances change?	Yes, but subject to discretion of individual owner	• Flexible drafting leaves decision-making in discretion of beneficiary <u>or</u> fiduciary • Trust terms can be modified with or without court
WINNER		USE TRUSTS!!!!!

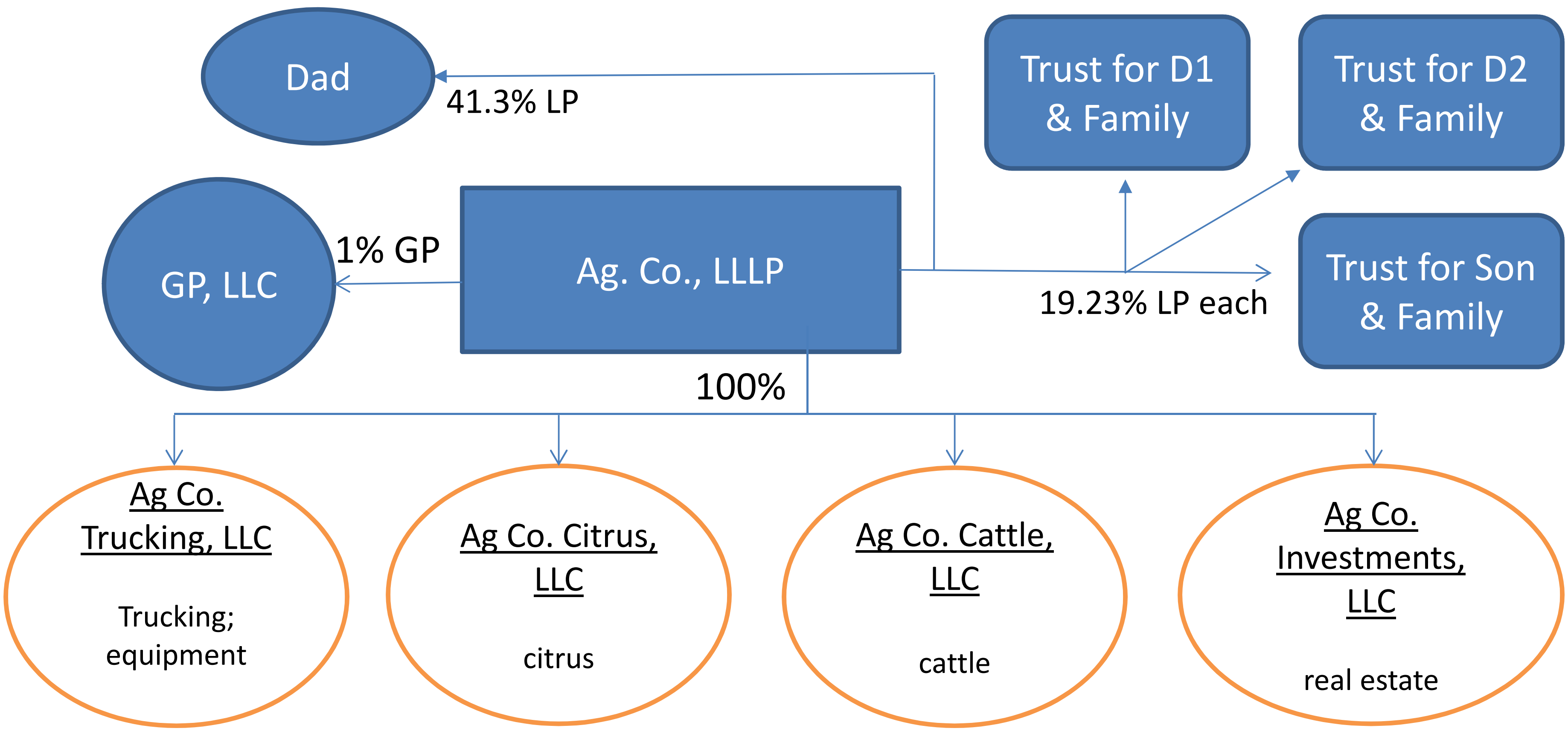
Scenario #3 – Post Gifts



Benefits

1. Each family line benefits equally from growth and distributions of Ag Co., LLLP
2. Trust assets generally remain protected from descendants' creditors
3. Growth and income of gifted LP interests avoid estate tax at Dad's later death
4. LP interests can be controlled inside trust by special purpose trustee(s) (including key employee or trusted advisor), which is especially important for D2's interest since she is not involved in the business

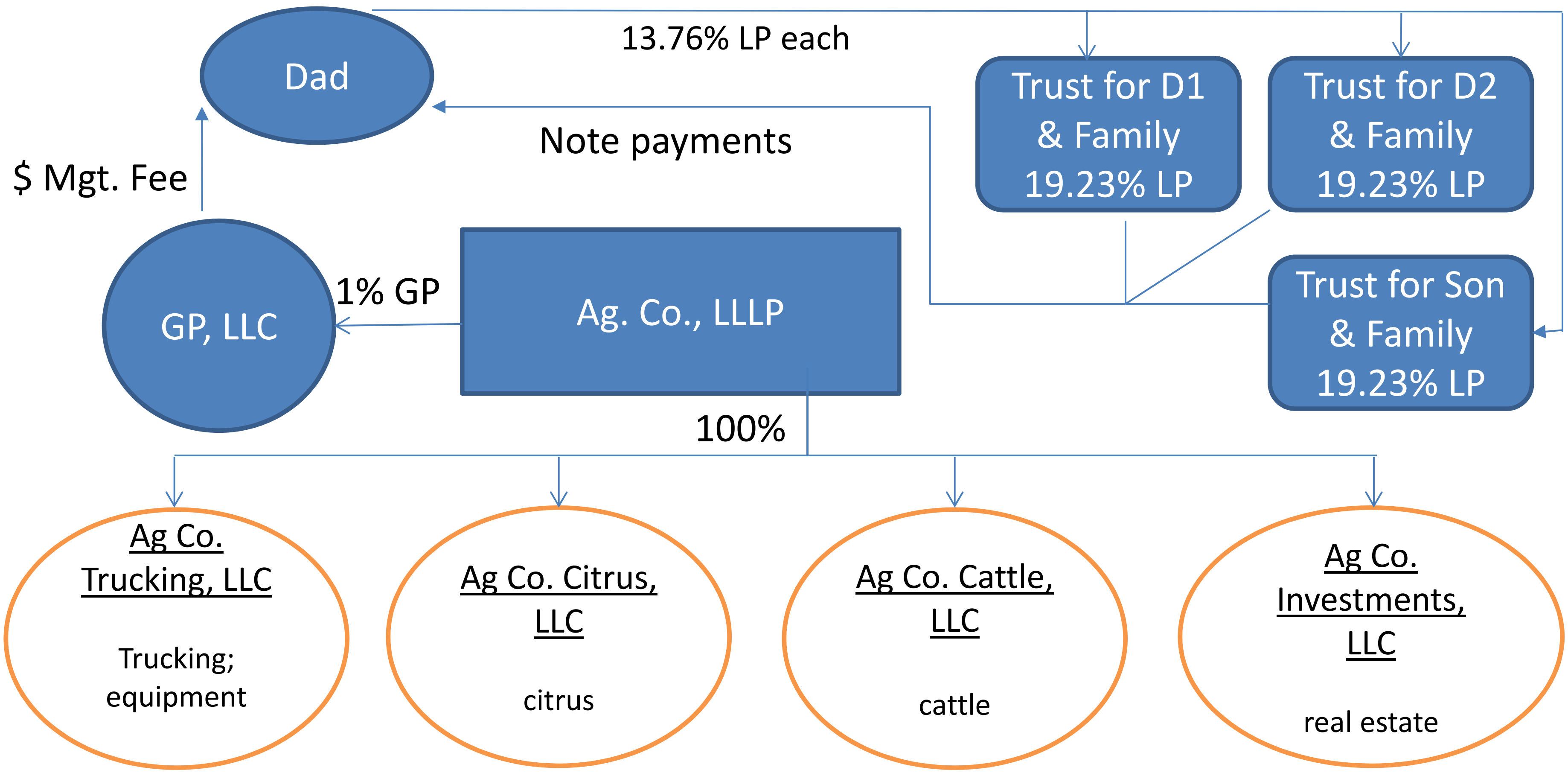
Scenario #4 – Maintaining Financial Stability Upon Dad's Retirement from Day to Day Operations



Scenario #4 (cont.) – Maintaining Financial Stability Upon Dad's Retirement from Day to Day Operations

- Transferring ownership does not mean the principal must give up the income stream necessary to sustain his or her lifestyle. Cash flow can be secured through other arrangements, such as:
  - Consulting / employment agreements
  - Shareholder/Partner loans
  - Preferred/frozen interests
  - Grantor Retained Annuity Trusts (GRATs) provide for annuity payments back to the principal, but the appreciation benefits heirs effectively transfer tax-free
  - Ownership can be sold (tax-free) for a promissory note providing for annual payments to the principal. Interest payments back to the principal can also be tax-free

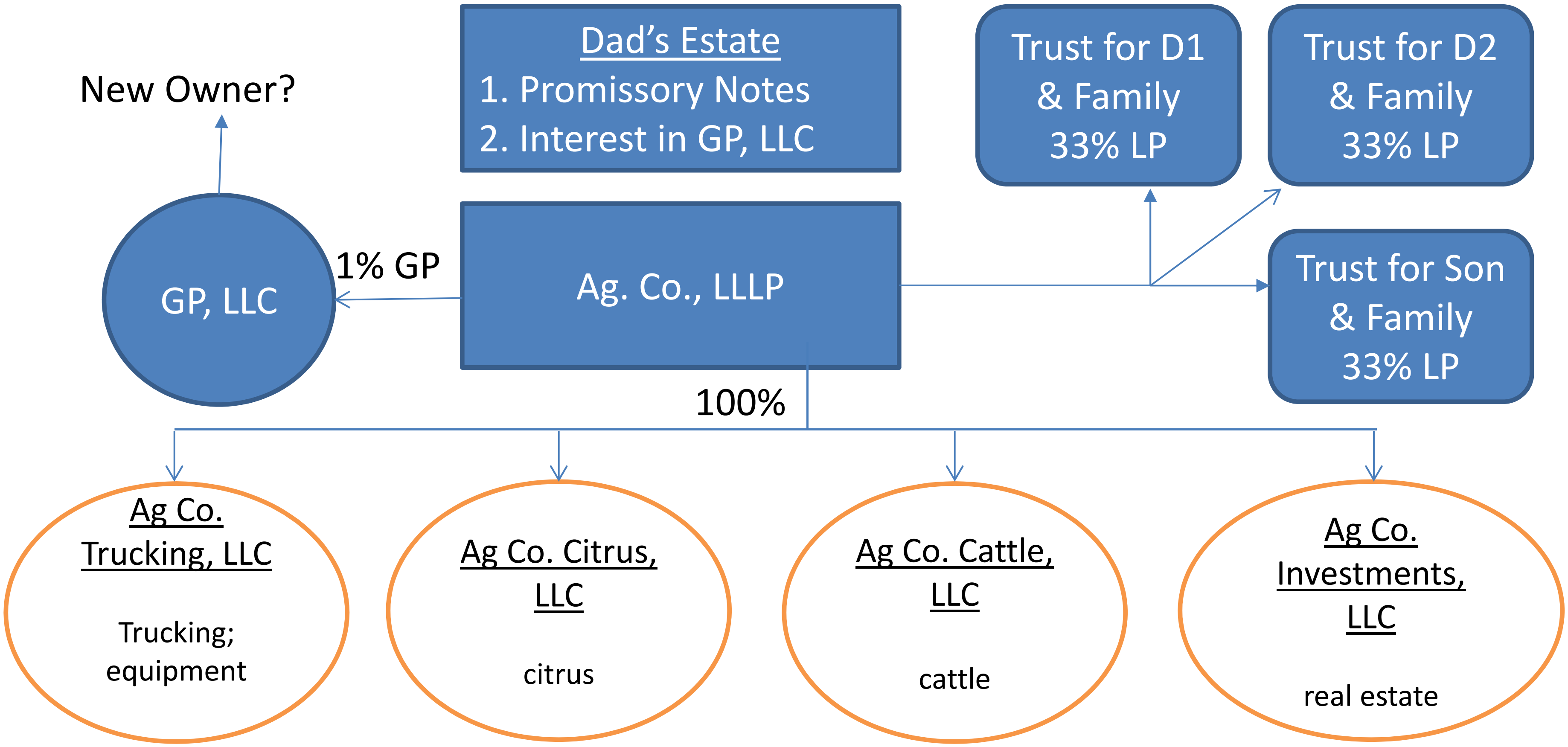
Scenario #4 (cont.) – Sale of LP Interests by Dad



Benefits

1. Income tax can be avoided on sale of LP interests to Trusts
2. Note payments from Trusts replace income lost from ownership of LP interests
3. Trusts can use distributions from Ag Co, LLLP to make note payments
4. Growth and income of LP interests sold avoid estate tax at Dad's later death
5. Income can be supplemented by management/consulting fee paid to Dad

Scenario #5 – Dad dies



Benefits
1. Only promissory notes and remaining interest in GP, LLC taxed at Dad's death; growth of LP interests avoids estate tax
2. Structure is in place for continuation of operations and smooth transition to new controlling partners

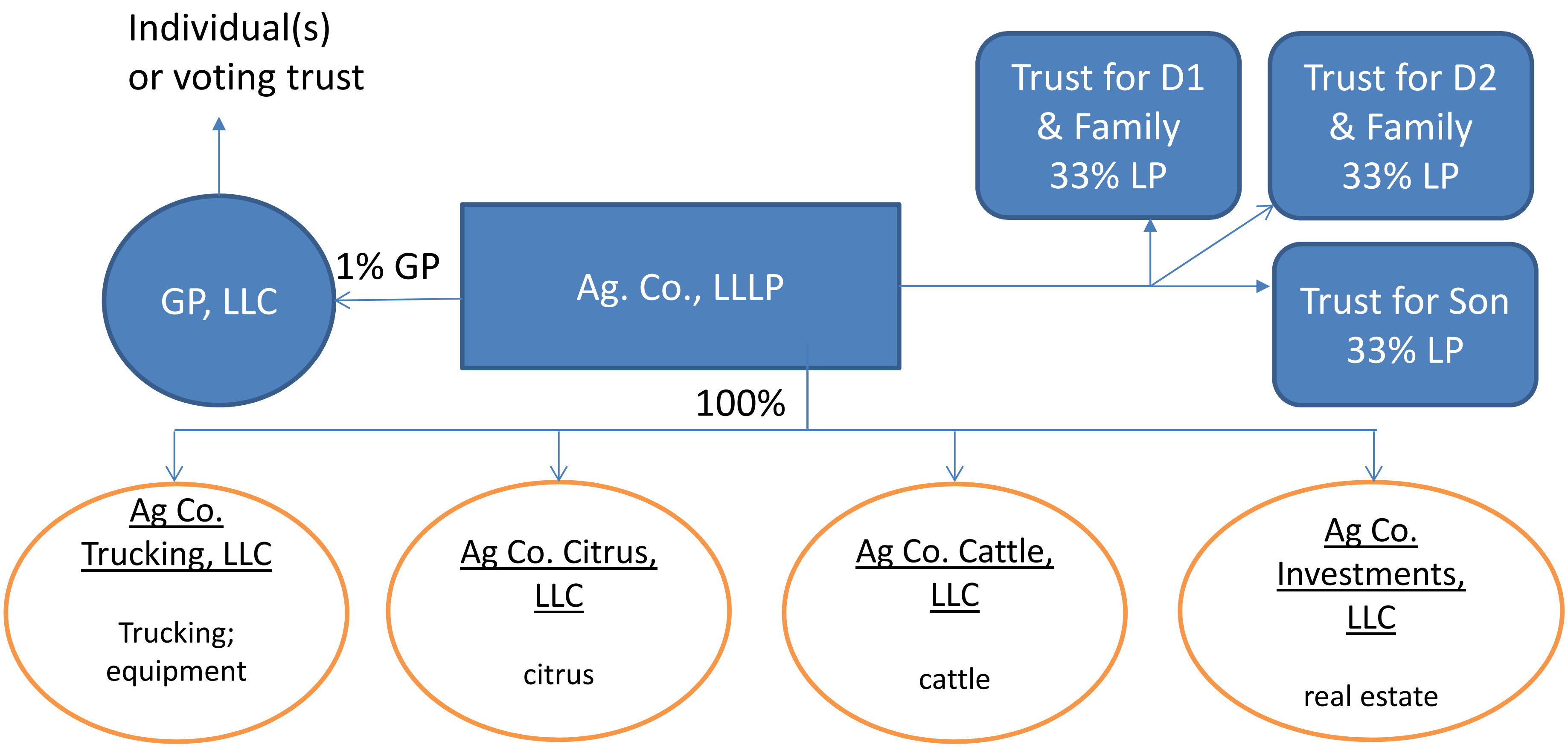
Transition of Control

- Individual(s) vs. Voting Trust
  - Voting Trust permits the controlling interest to be managed by an individual or board of fiduciaries. The board may include anyone, including key management, outside advisors, family members, etc. The benefits of ownership still overwhelmingly accrue to the trusts for family members.
  - Principal can define the procedures, restrictions, limitations, guidelines, etc. for the management of the voting interest under the terms of the voting trust. The fiduciaries have a duty to abide by the principal's intent
  - Fiduciaries of voting trust do not run day to day operations; they appoint the individuals who are responsible for day to day operations
  - Individual ownership of voting interest means that the individual solely controls the company, which may or may not result in fulfillment of the principal's vision
- Incorporate advisory board consisting of outsiders
  - Provides for outside expertise and oversight, but may not grant control
  - Important to have formal structure for appointment, removal, etc.
  - Board or trusted outsiders can have approval authority over certain decisions such as management compensation/bonuses, sale of the business, etc.

The Importance of the Governing Agreement

- Importance is magnified after Dad's death.
- Essential provisions
  - Clear chain of authority, including appointment of, or procedures for choosing, successor managers
  - Transfer restrictions to prevent unwanted owners
  - Buyout provisions to sever relationship with hostile partner
    - Put rights – owner can force the company to redeem the owner's interest at the price and on the terms set forth in the agreement
    - Options – Company and remaining owners have right of first refusal to purchase interest from a seller looking to "get out"
    - Procedure for determining value and the method of payment should be set forth in the agreement
  - Limit opportunity for excessive compensation
    - Ex: require compensation decisions to be approved by trusted advisor(s), such as independent board
  - Alternative dispute resolution provisions (e.g., arbitration, mediation) to preempt lengthy and costly litigation and to avoid publicity of disputes
  - Unsuccessful litigants should be required to pay prevailing party attorney fees to deter unwarranted litigation
- Communicate to next generation!

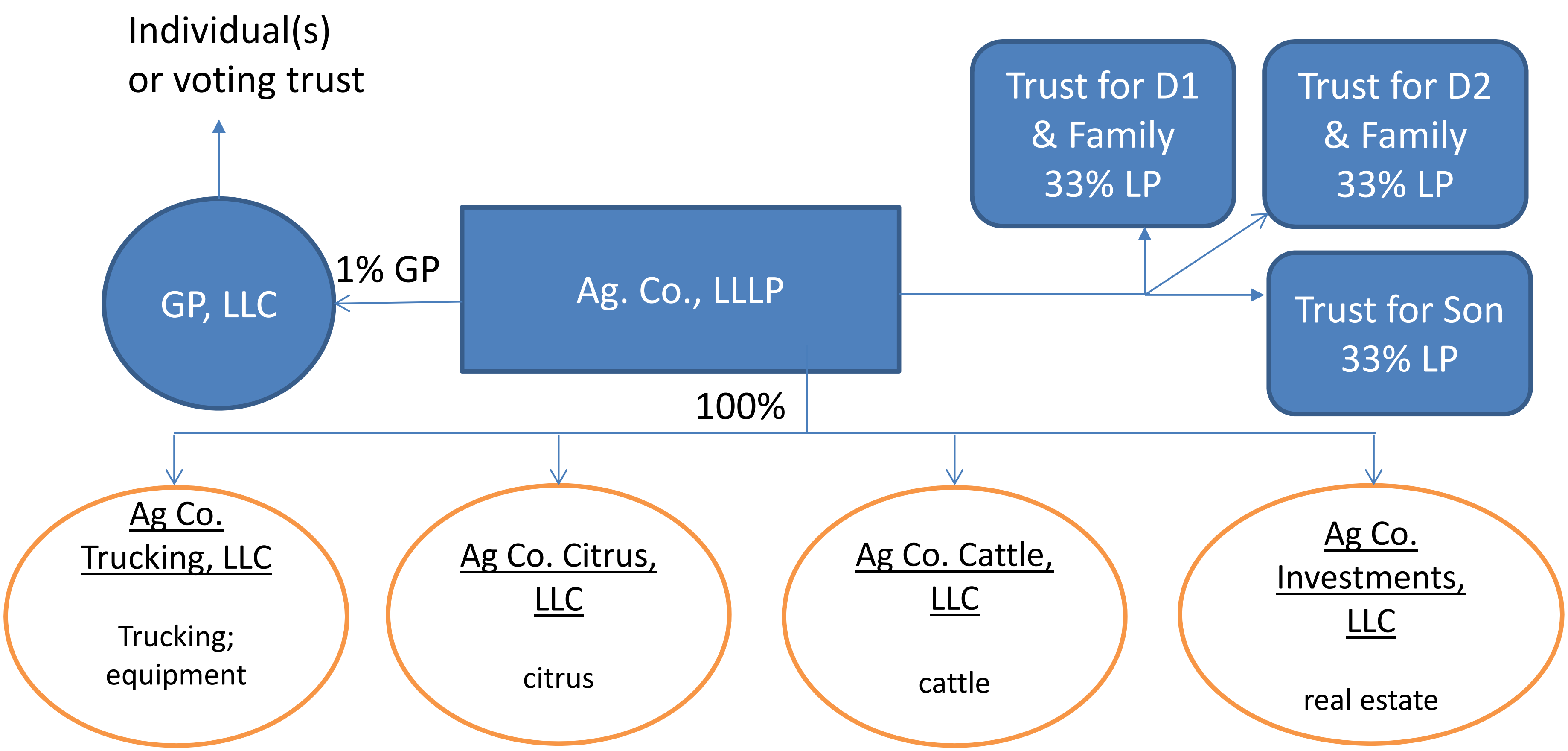
Scenario #5 (cont.) - Maintaining Flexibility for Future Transfers of Ownership



Flexibility

1. Beneficiaries can be granted power of appointment over trusts
2. Trusts generally can be modified with or without court involvement
3. Ag Co can add new investments by creating additional subsidiary without impacting operations of other business lines. All 3 family lines benefit

Scenario #6 – Managing Family Conflicts: D2 wants out!



<u>Options</u>

1. Ag. Co redeems 33% LP interest held by D2 Trust, which benefits S and D1 equally. Redemption could be made with cash or even one of the sub-LLCs.
2. Trust for D1 & Family and/or Trust for S can buy 33% LP interest from D2 Trust

- Under either option, the partnership agreement should contain terms governing the buyout procedures in the event the parties are not otherwise able to agree on terms

Managing family conflicts

- The best way to avoid future conflicts is by establishing a clear plan during life
  - Heirs are much more likely to agree when the principal is alive and in control
  - Communication from the principal is critical (regular family meetings)
  - Lifetime planning reduces the number of issues left to fight about post-death
  - Separate business lines into separate entities so that family members receive only those portions of the business in which they want to be involved.
  - Establish a mission statement and business plan for the future of the company. This provides guidelines for future management and owners
  - Consider establishing an advisory board that includes non-family members
    - Outsiders often play a critical role in maintaining family harmony because they can provide balance and cover for business decisions. The views of an independent trusted advisor can resolve deadlocks.
- Comprehensive agreement governing ownership is a must – See slide 34 for essential provisions
- General Rule: Voting control of the business should remain with those active in the business

Why is Succession Planning Important?

- Minimize Taxes
- Creditor/Divorce Protection
- Business Continuity
- Preserve Value
- Avoid & Resolve Family Conflicts
- Define Management

With proper planning, your business can be one of the few that survive to future generations

GET STARTED NOW!