Farhad Aghdami presents "Key Considerations for Successful Business Succession Planning"

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On November 29, 2018, the Estate Planning & Probate Section of the Atlanta Bar held the 15th Annual Estate Planning Forum at *Nelson Mullins Riley Scarborough, LLP* in Atlanta, Georgia. The Section was honored to welcome Farhad Aghdami, the managing partner of the Richmond, Virginia offices of *Williams Mullen*, as a featured speaker. Mr. Aghdami delved into the complex tax and non-tax strategies to be considered when planning for the succession of a business. Below is a summary of Mr. Aghdami's presentation.

Overview:

The ultimate goals of succession planning are to understand the true value of the company, to preserve that value and its future growth potential, and to pass it forward intact. The only way to successfully accomplish these goals is to plan carefully. To do that, planners should keep in mind the following key considerations:

- Understanding Traits of Successful Owners
- Transferring Control: Retaining or Selling
- Identifying (Other) Key Players
- Planning for Family Dynamics
- Maintaining Cash Flow
- Valuing the Business for Gift and Estate Tax Purposes
- Aligning the Business Succession Plan and the Estate Plan

Before discussing the key considerations noted above, it is important to consider several steps in business succession planning. The first step is to create basic estate planning documents, including wills and revocable trusts, that take advantage of the $11.18 million basic exclusion amount ("BEA")[1] that is available to each individual U.S. citizen or U.S. permanent resident. It is common to re-title assets among spouses to make full use of the BEA. It may also be appropriate to include provisions relating to the retention of business assets and stocks in trusts in estate planning documents, to use business assets to fund the shares for the children who are active in the business and provide equalizing distributions of other assets to those children who are not involved in the business, to begin liquidity planning, and to consider the use of an irrevocable life insurance trust to provide a source of liquid assets for the payment of estate tax.

In addition to providing basic estate planning, planners should consider advising clients on the importance of assembling a team of professionals including accountants, insurance agents, financial advisors, and appraisers. A business succession planner would also need to study the

[1] Mr. Aghdami's presentation was made in November of 2018, when the BEA was $11.18 million. The BEA for 2019, the year in which this article is being published, is $11.4 million.

client’s business and non-business assets, and assess the younger generation’s commitment to the business. With that information in mind, the planner can better formulate an appropriate plan.

Understanding Some Common Traits of Successful Business Owners:
Understanding your client’s business starts with understanding your client, the business owner, because the business and the owner are deeply intertwined. Although every client is unique, successful business owners often share certain characteristics, including self-esteem which is strongly tied to their position, a domineering personality, an immortality complex, and a fear of opening Pandora’s Box (whatever that may mean to them). While these characteristics may not make for a warm and fuzzy first meeting, a good planner understands that such traits form the basis of the client’s success with his or her business. Before your client even walks in the room, recognizing and appreciating those characteristics will facilitate your success in planning for a successful business transition.

Transferring Control: Retaining or Selling the Business:
Of course, for any business owning client, the biggest question for a business transition is also the most obvious: Should a client keep the business in the family, or sell it?

Option 1: Retaining the Business in the Family:
Although many business owners want to retain their business within the family, that is not always the best financial decision. Family businesses are at a great risk during the generational transfer process. Only 30% of family-owned businesses survive into the *second* generation of family ownership, and just 15% survive into the *third* generation.

According to case studies, family transitions generally fail for a few key reasons:

- 60% fail because of poor interactions between successor family members
- 25% fail because the heirs were not prepared to manage the business
- 10% fail because of lack of funding for estate and gift taxes

Business owners must be educated on these harsh realities. If the client wants to retain the company within the family, planning for each of these factors is essential to ensuring a successful transition.

The timing for the transfer of control is critical. A premature transfer can make the successor ill-prepared to assume the role, and a late transfer can lead to a power struggle or a leadership vacuum. Even if the client has identified a successor, the decision does not necessarily need to be announced right away. The successor’s abilities as a business leader can be developed gradually, before the business owning client is ready to sell or retire.

Option 2: Selling the Business:
The other option for a business owner is to sell, which brings a different set of challenges. For each of the concerns listed below, the planner’s role is to educate the client on the market realities and to develop a plan to help ensure a successful sale.

The first and perhaps biggest of these challenges is valuing the business accurately. A business owner may have an unrealistic expectation about the value of his or her company. The client's sense of a company's value may be driven in part by emotional factors, such as the prestige and symbolic significance of ownership and a sense of personal accomplishment for the hard work invested in building the company. Thus, if the market value seems lower than what the client believes the value to be, the client may be reluctant to sell.

Lack of qualified buyers is another problem business owning clients face. Your client may be hard to replace, especially if the company relies excessively on his or her individual capabilities, traits, and goodwill for its success. Even a client who is open to selling a business to someone outside the family often wants to see his or her legacy continue intact.

Finally, timing can also be an issue, since a favorable seller's market will not necessarily coincide with the client's timeframe for retirement. A good plan should give an owner the confidence to sell at the right time, even if it is before retirement age.

Identifying (Other) Key Players:

Early in the process, a good planner should identify all of the key players that contribute to the business's success. Just as the key players support the business in its operations, they will be crucial to a successful transition. Key players should be interviewed when beginning the planning process. In the areas where they have intimate knowledge of how the business operates, they can provide critical insights to support the planning.

Identifying and interviewing these individuals will also help the planner begin to outline the roles of those individuals going forward, for instance: Do they continue as they are? Do they need additional training to support the transition? Should they be transitioned out? These questions will depend on the client's goals. The broad goal is to maintain overall profitability, but the client may have particular goals for those who serve the business.

Some of these key players will be obvious (for example, the business's accountant, who can shed light on current business losses or provide other valuable insights that might be missed if the planner is only interacting with the business owner), but a good planner should look beyond the obvious candidates to other individuals, particularly a business owning client's spouse. Spouses may be privy to the good, bad, and ugly of the business and to the client's desires and wishes. A simple conversation with the spouse, provided the client approves and waives confidentiality to that extent, can lead to invaluable insights.

Planning for Family Dynamics:

A conversation with the spouse also serves another important purpose, because, regardless of whether the business is family-run, the business owner needs to consider, if not involve, his or her family in the planning process. It may not be necessary for family members to be active participants in the overall planning process, but it is important to set expectations accordingly. Just as the business owner's life is tied up in the business, the family is bound to the business as well.

These considerations are more acute for a family business, where feelings of familial entitlement must be addressed, than for a non-family business. Family members often see career opportunities in the business as a birthright, but for the business to succeed, decisions relating to job growth should be based on merit, competence, and sustained performance – not on mere familial relationship. For those family members who feel a sense of entitlement, the paradigm ought to be reframed as an opportunity to earn their place in the family business. This can be accomplished by having the family identify measurable standards and criteria for hiring, termination, retention, and promotion. Establishing clear definitions of roles and objective criteria for success will ensure a business development path for the family member, as well as for other employees.

Dealing with the children of the business owning client is especially tricky. In addressing the question of who gets what, should be to treat the children in business and the ones not in business "fairly," and that means the children might not be treated "equally." If there will be one or more children who can run the business well and wish to do so, the planner should focus the efforts on shifting the business to the children at the lowest possible transfer cost, while keeping the business owner reasonably comfortable in retirement. If there are children who are involved in the business and others who are not, the business owner might need to transfer business assets to the children who are involved in the business and transfer other assets of an equivalent value to the children who are not. If non-business assets are insufficient to accomplish that balance, then a better option may be to separate non-operating assets from the business and give those to the children who are not involved in the business. Where multiple children are involved in the business, the client would be well-advised to choose a leader among them and to retain a mechanism which brings control back to one child if ownership is divided among multiple children. The business owning client could also consider opportunities for splitting the business, with each child being given a separate business or line of business.

Maintaining Cash Flow:
Cash flow planning is essential to the peace of mind of business owning clients. Their businesses are the way they put food on the table, and maintaining an appropriate cash flow will facilitate the transition. By contrast, clients will be reluctant to give up control if their personal financial circumstances are not adequately guaranteed.

Identify sustainable future sources of income. The savvy planner can shift a business owning client's sources of income to streams of income that are contractually assured and that will survive the transition, such as rental payments, salary continuation payments, consulting fees, qualified and non-qualified deferred compensation, non-compete fees, buy-out payments through an installment sale, self-cancelling installment notes, and private annuities.

Valuing the Business for Gift and Estate Tax Purposes:
The tax consequences of a business transition — whether a sale, gift, or another type of transfer — depend fundamentally on the value of the business, but valuing the business for tax purposes is difficult. Unlike with stocks or real estate, which can be easily quantified from comparable sales in an active secondary market, businesses are infrequently sold and are rarely

similar enough for comparable sales to apply for the appraisal purposes. Thus, planners turn to appraisers, who apply various methodologies to estimate the value of the business.

Once a value has been placed on the business interest, savvy planners can apply various valuation discounts to "sweeten the deal." Several types of discounts are supported by case law, including a fractional interest discount, a minority interest discount, a lack of marketability discount, a lack of control discount, and a key person discount. By applying these discounts to a business succession plan, planners can transfer assets at a much lower taxable value. For example, a business with a fair market value of $20 million could be worth $13 million for estate planning purposes after a 35% discount for lack of marketability and lack of control is applied. This discounted value can be used for making gifts or using other strategies to minimize taxes.

Of course, planners must balance the financial benefits of various tax strategies with the possibility of an audit or lawsuit from the IRS. The amount and types of valuation discounts applied to businesses are often the focus of litigation in estate planning. Given the inherently subjective nature of valuation, the IRS knows that there may be tension between how taxpayers and the Internal Revenue Code value a business. The taxpayer has the burden of proof in demonstrating the valuation to be valid.

Aligning the Business Succession Plan and the Estate Plan:

Regardless of whether a business owning client retains or sells the business, the client should have an estate plan that aligns with the business succession plan. As noted earlier, it is important to create basic estate planning documents, such as wills, trusts, powers of attorney, and advance directives for health care (or a combination of health care powers of attorney and living wills). It may also be appropriate to include provisions relating to the retention of business assets and ownership interests.

Good planners go beyond the basics and utilize business assets for a variety of purposes: to fund the shares for heirs that are active in the business (equalizing other children's shares with other assets), to begin liquidity planning, and to provide a source of liquid assets for the payment of estate taxes through the use of an irrevocable life insurance trust.

As with any other type of client, the best plan for a business owning client will depend on factors such as the size of the overall estate, the needs of any dependents, any previous planning, and future goals and objectives.

Conclusion:

Addressing these considerations is critical for a successful transition plan. Of course, this list is not and could not be comprehensive, but it provides a strong foundation for planners to approach their clients.

The Section thanks Mr. Aghdami for his thorough and informative presentation at the forum. More information about Business Succession Planning may be found in the handout for this presentation, which is available for download on the Estate Planning and Probate Section page of the Atlanta Bar Association website under "CLE Materials."

About the Presenter:

Farhad Aghdami is the Managing Partner of the Richmond, Virginia offices of Williams Mullen. He focuses his practice on wealth transfer tax planning and wealth preservation, business succession planning, and general tax planning. Mr. Aghdami is a 1989 graduate of the University of Virginia and a 1992 graduate of the Wake Forest University School of Law. He received his LL.M. in taxation from Georgetown University Law Center in 1995.

Mr. Aghdami is a fellow in the American College of Trust and Estate Counsel (ACTEC) and is the Virginia State Chair of ACTEC. He is listed in The Best Lawyers In America and was named the "Tax Lawyer of the Year" in 2015 and 2018 and the "Trusts and Estates Lawyer of the Year" in 2016 and 2019 by Best Lawyers. Mr. Aghdami was rated Band 1 in the Chambers USA High Net Worth Guide for Private Wealth Law. He previously served as an adjunct professor at the University of Richmond School of Law and taught at Washington & Lee University School of Law.

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