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How To Lower the High Cost of Dying – Business Succession 101

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It is often said that two things are certain in life: death and taxes. Unfortunately, many patriarchs of family businesses refuse to admit the inevitability of the first tenet.

We believe there are three key aspects to planning for the closely-held business: (1) who will manage the business after your death, or should it be sold; (2) how will the decisions be determined and implemented; and (3) how can death taxes be minimized with respect to the business. While robust estate tax exemptions ($5,450,000 per spouse at present) have helped this last factor, any successful business will outstrip this exemption. Regardless of how the business will be shared among your descendants (or others) it is crucial to consider and plan for on an ongoing basis. This article will focus on the third aspect of this dilemma, while a future article will focus on the first two elements.

We believe it is best to have children or other qualified executives own and run a business, and to have children who have no management of the business stay out its operations. For this reason, we commonly use Stock Purchase and Restriction Agreements to reorganize stock into voting and nonvoting interests in order to more easily move stock among family members.

Valuation of closely-held business interests is important.

Assume a business is worth $10,000,000 and has 100 shares of voting common stock outstanding. Each share is worth $100,000. Now assume that a recapitalization of the business occurs with nine shares of nonvoting common stock being issued for each share of voting common stock. There will be 1,000 shares outstanding, so each share will be worth $10,000. A reasonable buyer, however, will not pay the same price for nonvoting shares as for voting shares. Thus, the nonvoting shares are worth less. How much less is a matter for an appraiser to decide.

Assume a 25% reduction on the nonvoting shares. A nonvoting share will be worth $7,500, or $6,750,000 collectively; while the voting shares will still be worth $10,000 per share.

Now you can start to focus on making gifts, which may be tax beneficial. Voting shares can be given to those who will run the business, while nonvoting shares may be left to children who will not be involved in the business. This allows you to give value to your children who are not involved in the business (since many parents want to treat their children equally) while giving those who are running the business control over the business. While this still creates issues with buying out the nonvoting children shareholders, those issues are now more manageable because of the reduction in value of their shares and the use of more sophisticated planning techniques that can be used once this restructuring is accomplished.

This example only scratches the surface of what is possible in particular situations. There are many considerations to family business owners which should be explored, but this gives a taste of what might be considered as a starting point.

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