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Common Business Succession Planning Strategies

Service

Private Wealth

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Thoughtful succession planning can pave the way for a smooth transition and a thriving future for a company and its stakeholders. Here are a few techniques that business owners should consider.

Buy/sell agreements

A buy/sell agreement is an important agreement for any business with multiple owners. A buy/sell agreement is a binding agreement where a business owner agrees to sell his or her ownership interest in the business upon a specific triggering event, such as the owner's death or disability. This ensures that the business remains in the control of the original owners and can continue its operations when one of the owners is no longer able to manage the company.

The buy/sell agreement can provide for a plan for any or all of the following triggering events: (i) death of an owner; (ii) long-term or permanent disability; (iii) involuntary transfers (e.g., divorce or creditor problems); (iv) voluntary transfers; (v) deadlock; (vi) cessation of employment; and (vii) put/call options.

If a triggering event occurs, the buy/sell agreement will dictate whether there will be a purchase, whether the purchase rights are optional or mandatory, and who will have such purchase rights. The purchaser may be the other owners of the business (a "cross-purchase" agreement) or the business itself (a "redemption" agreement).

In addition, a buy/sell agreement will dictate how the ownership interest subject to transfer is valued. There are multiple ways to dictate the value in a buy/sell agreement. Some buy/sell agreements dictate that a predetermined value be used to determine the value of the ownership interest. Others dictate that an annual agreement of owners be used to determine the value. The most common valuation techniques are using a formal business appraisal or using a predetermined formula.

Finally, the buy/sell agreement will provide how the purchase is funded. This funding mechanism is dictated by the triggering event. If death is the triggering event, the company or owners may purchase life insurance on any or all of the owners. If death is not the triggering event, or if life insurance is not feasible, the buy/sell agreement may provide for the terms of a built-in promissory note to fund the purchase. The owners may also agree to contribute assets to a common fund to facilitate the purchase.

Recapitalization

Recapitalizing a business by dividing its ownership into voting and nonvoting interests can yield significant benefits, particularly when formulating a succession plan, and can be used whether the underlying business is structured as a corporation, limited liability company, or partnership. By creating separate classes of voting and nonvoting interests, an owner can retain voting control over the business while transferring nonvoting (economic) interests to family members, key employees, or potential successors. This is particularly beneficial when a business owner is facing potential estate tax exposure and is considering gifting and/or selling part of the business to reduce the size of his or her taxable estate.

Recapitalization simplifies the process of transferring ownership to the next generation, ensures continuity in critical business decisions, and maintains a stable leadership structure while the business owner transitions out of the business. Nonvoting shares can be transferred gradually, providing heirs/successors with an economic interest in the business without necessarily giving them decision-making power until they are ready to assume leadership roles. Additionally, the nonvoting shares that are sold or gifted to the owner’s family members may be subject to valuation discounts for lack of control which can minimize the use of the owner’s estate and gift tax exemption.

Right of first refusal

A right of first refusal (ROFR) grants the owners of a business the right to match or exceed any outside offers to purchase shares of the company before they are sold to a third party. This allows business owners to retain greater control over who becomes a shareholder and prevents unwanted outside influences from disrupting the company's culture and vision.

If a business owner is transferring ownership of his company to his children or other family members, he or she may be concerned about one of the successors selling their share to an outside party and disrupting the structure of the business. Implementing a ROFR provision in the business’s governing documents can ensure the other family members have the opportunity to keep the business within family control and maintain ownership stability.

ROFR provisions can also help minimize disputes among the business's owners. They delineate the process for transferring ownership ahead of time and can also provide a controlled valuation process for an owner's interest in the business. Many ROFR provisions set forth a predetermined valuation methodology for ownership interests to prevent undervaluation or overvaluation disputes during ownership transfers.

Gifts or sales to an irrevocable trust

Another key strategy to consider for succession planning is a gift or a sale of business interests to an irrevocable trust.

For an individual business owner seeking to utilize some or all of their lifetime estate/gift tax exemption (currently $12,920,000), he or she can gift the interests to an irrevocable trust for the benefit of descendants or other family members. The gifted assets will be removed from the donor or the ("grantor's") estate for tax purposes. In addition, the property will also be shielded by the powerful protections offered by the trust against potential future creditors (including marital claims).

The value of a gift consisting of non-controlling business interests can also be discounted for lack of marketability or lack of control. This allows the grantor to transfer the business at a considerably lower cost and any future appreciation on the asset will escape estate tax.

Another option is a sale of the business interests to an irrevocable grantor trust in exchange for a promissory note. The asset is removed from the grantor's taxable estate and substituted with a stream of income. Since the grantor is treated as the owner of the trust for income tax purposes, there is no income tax consequence to the grantor. Any appreciation following the sale in excess of the Applicable Federal Rate will pass to the trust free from estate and gift tax.

At a later date the grantor can choose to forgive some or all of the debt up to their remaining lifetime exemption, if that is desired. Alternatively, the business owner can also structure the transaction as a partial gift and partial sale.

Contact us

If you have questions or would like to discuss how these strategies and others can be used to help meet your planning goals, please contact a member of the Husch Blackwell Private Wealth Team or your Husch Blackwell attorney.

Read more about the Benefits of Succession Planning.