

Insights for Entrepreneurs

Part Five: Family-Owned Business Succession Strategies

Working as part of an integrated advisory team, your Morgan Stanley Private Wealth Advisor can help you make well-informed personal wealth management decisions at every stage of your company's development. Our goal is to provide you with the information, insight and resources needed to help you reach your personal and professional goals. We are here to help you answer the key questions that arise at the intersection of your business strategy and your personal wealth management plan.

When and How Do I Transfer Ownership of My Business to Younger Generations?

Raising children who are not only willing, but also capable, of taking over the family enterprise is an exceptional achievement in its own right. It can also create complex challenges related to your own retirement planning, family dynamics and the operation of your business. In terms of timing, however, the same principles apply whether the younger generation will continue running the company, or if they are just holding equity as passive investors. In order to manage transfer taxes, it is best to implement planning in advance of significant appreciation in the business.

When family business is successful and the founding generation wishes to retire, estate and gift tax rule can make it costly to transfer ownership to the next generation of family members. Consequently, it may be better to begin to transfer ownership before retirement

using gifting and other wealth transfer strategies described in the Estate Planning Structures sheet of this series. These include, but are not limited to:

- Grantor Retained Annuity Trusts
- Intentionally Defective Grantor Trusts
- Outright gifts of shares under the lifetime gift/estate tax exemption

Your family can also consider an employee stock ownership plan in order to provide liquidity to the retiring owners on a tax-advantaged basis, or an installment sale to the next generation, which would allow your children to use the cash flow of the business to pay you as the retiring owner.

How Do I Control What Happens to My Business at My Death?

A shareholder or operating agreement of your entity affects how your equity in the company passes, and the valuation, liquidation and other rights of your successors in interest. For example, you

may provide that the equity interests pass under your will. The governing instruments may give "put rights" to your beneficiaries, or provide for mandatory redemption. The voting rights of nonemployee beneficiaries may also be limited so that management of the company remains with the employee shareholders. It is important to identify these provisions in your existing governance documents and review any buy/sell agreement to make sure that they are in accordance with your wishes.

Consider whether additional planning is necessary. For example, if your family wishes to retain control of the company, will they have the cash flow to maintain their lifestyle? If they will need cash, how will the company raise the cash?

How Can I Plan For a Seamless Transition of the Company?

The keys to a successful transition of ownership are to have a clear succession plan in place, and to keep it up to date.

INSIGHTS FOR ENTREPRENEURS

In order to create a plan, there are a number of considerations regarding the transition of ownership and management that must be considered. This differs quite markedly depending on whether your family will continue to manage the company, or if operational control will pass to your management team.

FAMILY BUSINESS SUCCESSION

If the goal is to pass the business ownership and management to family, a succession plan may include:

- Gifts of equity to children, either outright or in trust, in a tax-efficient manner.
- Bequests of equity at death along with a liquidity plan for estate taxes.
 - The federal estate tax generally is due nine months after the date of death. If the estate consists primarily of illiquid business interests, consider life insurance funding, the potential for borrowing and any estate tax deferral opportunities for closely held business interests. For example, under current law, if the business represents a significant part of the taxable estate, the executor may be able to defer the tax and pay in installments over a 10-year period.
 - Consider the allocation of equity among family members. Will each child inherit an equal share? Should the equity pass only to the child who works in the business? Address family conflict issues that may arise based on shared ownership.

MANAGEMENT/EMPLOYEE SUCCESSION

If your goal is for employees to continue the business, you must have a sound and well-rounded management team. You should plan as far in advance as possible, prepare the company for transition and consider financing options and tax consequences. Methods of transferring ownership to key employees include:

- Employee Stock Ownership Plan (ESOP)
- Sale to existing or new management (with or without private equity investment)
- Gifts to key employees

A number of governance issues will also need to be settled to ensure that your company can continue to operate effectively:

- Who are the key employees who will oversee day-to-day operations and serve in management positions?
- If your family retains a significant ownership stake in the company, will any or all of them participate in management?
- How will conflicts be resolved between family members and the family and company management?

THE INSIGHTS FOR ENTREPRENEURS SERIES COVERS THE FOLLOWING ADDITIONAL TOPICS:

Choosing a Business Structure

Early-Stage Trust and Estate Planning

Overview of Wealth Planning Structures

The Public Sale of Privately Held Businesses

Philanthropic Strategies and Structures

Understanding Equity Compensation

FOR FURTHER INFORMATION

If you wish to discuss business succession issues and planning techniques in the context of your personal and professional goals, please speak to your Private Wealth Advisor. He or she can schedule a meeting with a Morgan Stanley specialist in Wealth Planning, or in Family Governance and Wealth Education.

This material has been prepared for informational purposes only and is subject to change at any time without further notice. Information contained herein is based on data from multiple sources and Morgan Stanley Smith Barney LLC ("Morgan Stanley") makes no representation as to the accuracy or completeness of data from sources outside of Morgan Stanley Smith Barney LLC. It does not provide individually tailored investment advice. Be aware that the particular legal, accounting and tax restrictions, margin requirements, commissions and transaction costs applicable to any given client may affect the consequences described, and these analyses will not be suitable to discuss with every client. The appropriateness of a particular investment or strategy will depend on an investor's individual circumstances and objectives.

Tax laws are complex and subject to change. This information is based on current federal tax laws in effect at the time this was written. Morgan Stanley Smith Barney LLC, its affiliates, Financial Advisors or Private Wealth Advisors do not provide tax or legal advice. Clients should consult their tax advisor for matters involving taxation and tax planning, and their attorney for matters involving trust and estate planning and other legal matters.