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PRIVATE BANK

The Well-Prepared Business Owner

Your children, your successors

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Transforming your business into a legacy

Business founders typically devote years to building their companies. Many want their businesses to continue beyond their lifetimes, managed by their children and, possibly, future generations.

If this is your desire, you will want to devote some of the same kind of energy, thought and planning that it took to build your business to help transform it into a sustainable legacy.

How hard is it to create a legacy business? Statistics regularly quoted to describe the survival rate of family businesses are often more anecdotal than scientific. They tend to assume a business existing for just one or two generations means the enterprise "failed to survive." Yet, some founders or second-generation owners feel they have succeeded when their family businesses reach a certain value and can be sold at a profit.[1]

Family business survival rates are also difficult to calculate because it is challenging to pinpoint what a family business is for comparison purposes.

The range of what might be called a "family business" is astonishing: from small, family-owned shops to publicly traded behemoths in which controlling shares are held by sprawling third and fourth generations.

The U.S. Department of Labor, Bureau of Labor Statistics (BLS) keeps track of "employer establishments," defined very simply as businesses that have employees. These statistics suggest it is more the exception than the rule for any business to last even as long as the first generation's lifetime. The BLS reports that:[2]

[1] Melissa Carey Shanker and Joseph H. Astrachan, "Myths and Realities: Family Businesses' Contribution to the U.S. Economy—A Framework for Assessing Family Business Statistics," Family Business Review, vol. 9, no. 2, Summer 1996, SAGE Publications.

[2] U.S. Department of Labor, Bureau of Labor Statistics: Survival of private sector establishments by opening year, March 2023.

The U.S. figures suggest that sustaining a business of any kind is difficult. Yet, the challenge can be met—if that is what you and your succeeding generations desire.

Already, you have beaten the odds by building a successful business. The question now is: Do you want to transform it into a sustainable legacy?

What do you want for your family?

For more than 200 years, J.P. Morgan has been intimately involved in successful generational transitions of family businesses around the world.

Our experience with family businesses teaches us that owners typically have a simple choice between two options:

01 LEAVE IT FOR LATER	If the business founder does not resolve issues before a transition event arises, these issues may end up in court—a costly, adversarial process that inevitably causes the business to suffer economically and tears family and employees apart.
02 FACE IT NOW	If the business founder addresses succession issues thoroughly, thoughtfully and in a timely manner, a business has a much greater chance of surviving into future generations.

Handing down a properly prepared business to the next generation can provide your family with a continuing source of wealth, opportunity, unity and identity.

Accomplishing a successful transition takes courage, time and work. Many have done it before you, and we have helped them. We are ready to help you too.

In this publication, we share some of our insights into the issues that you will likely need to address.

Key challenges faced when handing down a family business

The greatest dangers to family business succession tend to arise in the typical family business "life cycle":

- **Anticipating the transition**—Failure to identify and prepare a next generation of leaders so they are ready, willing and able to run the business
- **Transferring the business**—Inadequate estate planning, resulting in both a lack of liquid assets to pay estate taxes and poorly planned disposition of business assets among family members
- **Operating under new leadership**—Failing to install the right support and governance structure
- **Sustaining capital for the enterprise**—Not balancing the capital needs of the business against the risks of concentrated wealth
- **Agreeing on a vision over the long term**—Family discord

Why don't more business owners avoid these potential obstacles if it is so easy to identify them? Two of the most common reasons are:

1. Owners often do not like to contemplate, let alone plan for, a transition regardless of how soon it may be.

2. Even if transitions are contemplated and planned for, they are challenging to get right.

Too much control can create weakness

Business owners, whose vision, drive and decision making are at the core of helping their businesses succeed, often want to control every aspect of their companies.

Yet, when owners retain too much control for too long, it can create weakness in legacy planning. Development of the next generation of management and shareholders can be stunted. And a business that lacks capable successors is vulnerable.

If an owner dies before transition planning is complete, the business can be devastated. But even gradual transitions can fail if the next generation is not properly prepared to step into the owner's shoes.

Fortunately, there are constructive ways to balance an owner's desire to remain in charge with the next generation's need to learn and assume real control.

Identify, plan, succeed

We find businesses are more likely to succeed into the second, third, fourth and even fifth generations when they have prepared for five critical issues:

1. Sudden events

Successful legacy businesses have contingency plans for a sudden management change, just as they do for other catastrophic events. Change-of-management plans should be regularly reviewed and revised as circumstances evolve:

- Articulate a clear vision of the company's future
- Define the roles and responsibilities of all future players
- Have unifying structures to connect the family and the business
- Allow family members a dignified and properly compensated exit that does not jeopardize the business

2. Orderly transition

Even if the current owner's withdrawal from the business is not expected to occur for a decade or more, management needs to acknowledge and prepare for succession. This preparation entails:

- Having a formal succession plan that has the key elements described in the contingency plan above
- Creating appropriate legal documents that can effectively make the succession plan a reality (see "Essential documents checklist" on page 20)
- Formally training interested younger family members and integrating them into the business

3. Liquidity/estate taxes

The U.S. federal estate tax rate is roughly 40%, and payment is usually due nine months after a person dies. Unplanned for, this federal tax liability can be a tremendous burden on a business, severely limiting reinvestment and distributions to shareholders. Even if the estate tax payment can be deferred, the principal and interest due in later years can hamper a business's competitiveness. Many families are forced to liquidate a business to pay the estate taxes due on it—often in a hurry and for less than the business's full value.

If you want your family to keep the company, there are actions you can take now to help reduce the estate taxes that will be due. (See "Clearing the tax hurdle" on page 10.)

4. Concentration

One of the greatest threats to the shareholders of a business is concentration. The business itself can be overly concentrated in, for example, a product, a select customer base, or an individual supplier. Concentration of personal wealth in private company investments is an equally critical issue. Nothing better illustrates the potentially unfortunate consequences of this risk than the experiences of many closely held businesses during the financial crisis of 2008. Many businesses were forced to dramatically reduce distributions to shareholders or beneficiaries. Some were forced to shut down.

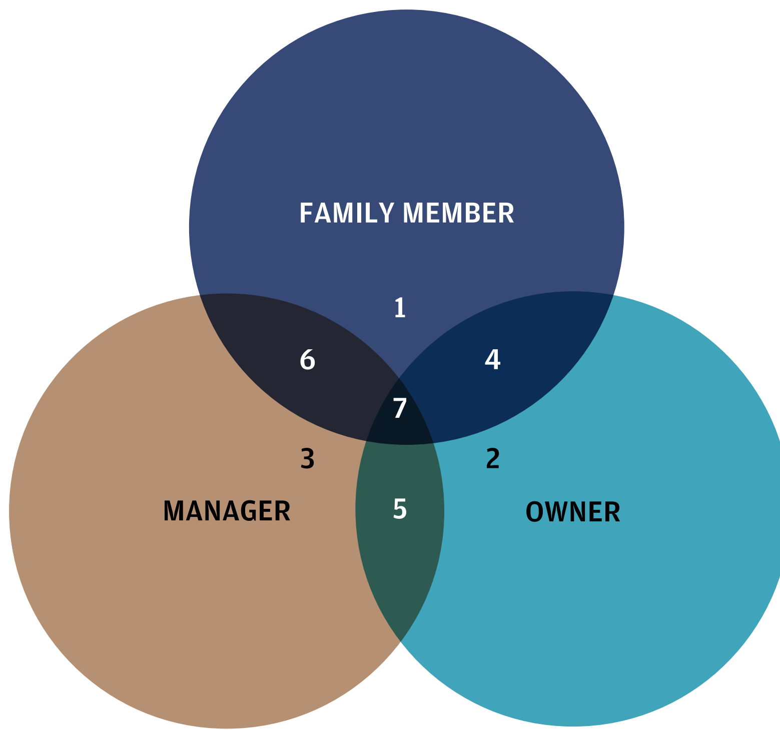
Safeguards against tough economic times include creating a complementary portfolio of assets to manage the owner's personal wealth. (For additional insights into this risk and a full range of potential antidotes, speak with your J.P. Morgan team.)

5. Family involvement

Successful family businesses anticipate and work to defuse potential family discord long before it arises. They do so by proactively addressing typical, systemic causes of such discord, taking into account the potential complexity of family business systems. (See "Family Business Systems" chart on the following page.)

FAMILY BUSINESS SYSTEMS

A variety of overlapping roles can create complex relationships that are often difficult to manage



One role–1 (family member only); 2 (owner only); 3 (manager only)
Two roles–4 (family member and owner); 5 (owner and manager); 6 (family member and manager)
All three roles–7 (family member, owner and manager)

Source: R. Tagiuri and J. A. Davis, "Family Business Review," March 1992.

Setting the stage for family harmony

Knowing where you want to go helps you get there. It is therefore important to articulate what your goals are for your immediate family, for each extended family member and for the business. Only then can you assess where these various goals converge—and possibly diverge.

Your plan

Five key elements are essential to creating a business succession plan that will help your family thrive:

1. Distribution policy

Policies governing distributions to stakeholders must be well considered, transparent and communicated to all family members. Provisions should be put in place so that the business can reinvest in itself in good times and potentially curtail disbursements during tough economic cycles. A well-articulated and transparent distribution policy also is critical to promoting harmony between family members who are active in the business and those who are not.

2. Control

What should be done about family members in successive generations who are not active in the business?

Will you permit the inactive to own stock? Should they own voting stock? Although it is possible for inactive members to own voting stock, closely held family businesses are more likely to succeed when all the stock, especially voting shares, are held by the family members who work in the business full-time and draw salaries. Consider putting a family governance plan in place that repatriates company stock back to the full-time employees.

3. Advancement

The thorny matter of meritocracy is raised not only when setting family members' compensation, but also when deciding which positions they occupy in the business. It is essential to establish a governance mechanism to address the issue, perhaps involving an independent committee or board so the business's best interests are served, and employees are neither rewarded nor punished for their status as family.

Questions that need to be answered include:

- What qualifications are required to work in the business?
- How should individuals enter the business and be promoted?
- How is compensation determined?

It is also critical to think about non-family employees who are key to the business. Healthy, ongoing businesses provide opportunities and financial rewards to anyone who contributes to their success. Care should be taken to align key employees' interests with those of the enterprise and its shareholders. A variety of approaches can accomplish this goal.

For example, key non-family employees may be given stock appreciation rights (SARs), which typically provide employees with cash payments based on the increase in value of a stated number of shares over a specific period of time.

An employee stock ownership plan (ESOP) also may help align employees' interests with the business's objectives, while generating liquidity for the owner. How this works: The company sets up an employee benefit trust. In turn, the trust, using funds loaned by the company, purchases shares from the company's shareholder(s). The company finances its loan to the ESOP with a loan that can be provided by a bank or the shareholders who are selling.

Depending on an owner's goals, he or she may retain a controlling interest or sell as much as 100% of the company to the ESOP. Under certain circumstances, owners may be able to defer recognition of capital gains realized from the sale of their shares to an ESOP.[3]

The ESOP trust holds the shares for the benefit of the employees and receives annual tax-deductible contributions from the company, with which it pays down the loan from the company. As the loan is repaid, the purchased shares are allocated to employee participant accounts as part of their compensation. When employees leave the company, they receive their vested ESOP shares, which the company or the ESOP generally buys back at the shares' appraised fair market value.

4. Entrepreneurial vitality

With multigenerational businesses, complacency is a bigger danger than many may realize—especially after the first couple of generations. A feeling may develop that the business has done well, and therefore always will. But, of course, no business is static; every company is either increasing or decreasing in value. To remain vital, all businesses must reinvest in themselves.

5. Escape clauses

There must be a safety mechanism that allows family members to leave the business without destroying it. Systems should be in place that allow individuals to exit in an orderly fashion. To that end, a buy-sell agreement should be in place, and answer such questions as:

- What is the value of the business, and who decides it?
- What is the buyout period for family members who wish to depart, and how will buyouts be financed?
- Will there be "look-back" provisions in case some members exit before the business is sold? Should those who depart early receive an additional payout?
- Should family members be permitted to leave the business? Should the value of a buyout be discounted so that family members are encouraged to remain?
- What would it take to sell the whole business, and how much family consensus should be required? A simple majority? A super majority?
- Should family members be given a right of first refusal as potential buyers of the business?
- How will the buy-sell agreement impact value for gift and estate tax purposes?

Family council

There is so much for family members who are involved in a closely held business to decide—and keep deciding—that you may want to create a family council to help:

- Communicate family values as they apply to the business
- Create and renew a common vision for the family enterprise
- Approve business policies and procedures
- Develop the next generation of leaders for the family and for the business
- Provide a forum to discuss new ideas and projects
- Educate the family on business issues
- Coordinate a flow of information from the business to the family
- Groom family members for a future seat on the board of directors

Typically, all the adult, equity-holding family members sit on the family council and meet yearly. Many families hold annual reunions in vacation areas, devoting just a day or two to the council's meetings.

The point of the meeting is to:

- Hear from management regarding business performance and its plans for the future
- Have an opportunity to ask questions and make suggestions
- Transfer the founder's legacy and culture to future generations

The next generations

Younger family members often are invited into various sessions to learn about the business. Some families even require the next generation to participate in some of the family's decision making and charitable giving to help prepare them for a seat on the family council or board of directors.[4]

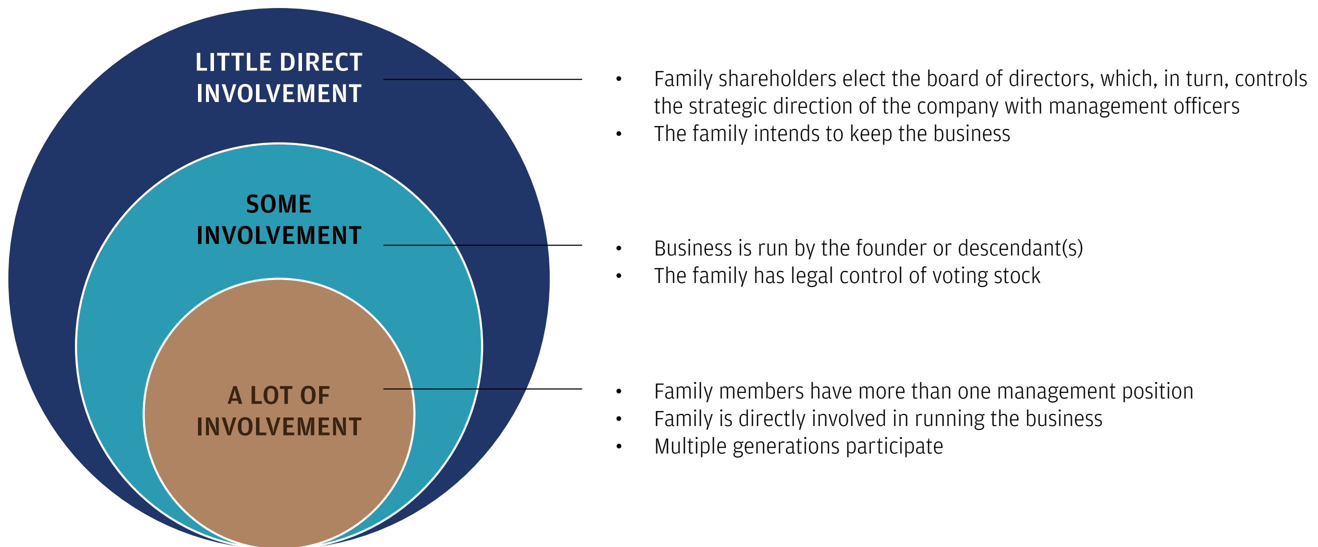
As families grow and become more dispersed, the family council can become increasingly important. By the third generation, it can be critical to promoting family harmony.

[4] Internal Revenue Code Section 1042 permits deferral of capital gain recognition for proceeds from a sale of at least 30% of a closely held C corporation to an employee stock ownership plan (ESOP)—if the seller has owned the shares for at least three years and uses the proceeds to purchase qualified replacement property (QRP) during a 15-month period beginning three months before, and ending 12 months after the ESOP transaction. QRP includes stocks and bonds of most domestic operating companies.

[5] J.P. Morgan hosts events for emerging family leaders, at which we offer insights into such key topics for family businesses as family governance, investment management, philanthropy and understanding the family legacy.

HOW ACTIVE ARE FAMILY MEMBERS IN THE BUSINESS?

Over time, levels of involvement tend to vary



Source: Melissa Carey Shanker and Joseph H. Astrachan, "Myths and Realities: Family Businesses' Contribution to the U.S. Economy—A Framework for Assessing Family Business Statistics," Family Business Review, June 1996.

Clearing the tax hurdle

Most business owners strive to reduce taxes and other costs of doing business. Yet, these same owners often ignore the dramatic toll U.S. estate taxes ultimately will take on their companies' value and long-term prospects— even when they truly want their businesses to endure and thrive with family members in charge.

Are you living this contradiction between current actions and future intentions?

Techniques

Find out by seeing how many of these six techniques you have used to reduce the impact of taxes on the value of your company:

1. Have you created a form of ownership of the business appropriate to your enterprise, taking into account that different entities are treated differently for tax purposes? Choices include: a general or limited partnership, a limited liability company, a Subchapter S or C corporation, as well as other forms of ownership. To select the appropriate form of ownership, it is important that you consult with your legal and tax advisors.

2. Have you transferred ownership interests into trusts for the benefit of the individual(s) you want to succeed you as owner(s) of the business? Did you know that you can transfer business ownership to trusts, yet still manage, and derive benefits from, the business?

3. Have you taken advantage of appropriate discounts that come with transferring closely held business interests in order to maintain the value of your wealth through effective transfer strategies? The IRS recognizes discounts for lack of control and lack of marketability.

4. Have you divided your company into common and preferred interests, taking care to ensure company earnings flow to the preferred and common interests as you want?

5. Do you manage your business to ensure the desired level of income earned by the enterprise flows to its current and future owner(s) in the form of salaries, dividends and other distributions as you want, without harming the existing corporate governance and ownership structure?

6. Do you manage the income and capital gains tax liabilities generated by the business to minimize the taxes that must be paid by individuals or trusts owning interests in the business?

These techniques are essential to consider if your business is based in the United States and you want family members to run it at some point.

Facts of U.S. business life

Along with the tremendous advantages of having a business in the United States, there are some harsh realities that are in every U.S. business owner's best interests to acknowledge.

The value of the business one day may become substantial enough that transfer taxes will be due on the owner's transfer of the business's equity to other members of the family.

If a business's value is large enough, the federal government will redeem its roughly 40% share when the owner (or perhaps the owner's spouse) dies, and will insist, with only limited exceptions, on prompt payment of its share.

There is a great deal you can do to soften these realities—if your choices are timely, thoughtful and well executed.

It can be done

Often, what stops business owners from taking action, or from even planning to take action in the future, are concerns about losing control over their companies.

But you can reduce the impact of taxes on the value of your business without ceding all control and benefits from the company to your heirs.

Three key strategies can help make the difference:

1. **Time it well**—The single most economically beneficial technique U.S. individuals can use to transfer significant amounts of wealth tax-efficiently is to use all their gift tax exclusions before their business assets appreciate in value. This is also known as an estate tax freeze strategy. The longer you wait to use your gift tax exclusion, and the larger your business grows, the greater the government's share will be.

   In addition, it is widely acknowledged that a minority interest in a private business is likely subject to a discount for lack of marketability and a discount for lack of control. Combining discounting strategies with time to allow for appreciation can lead to significant wealth transfer.

2. **Maintain control**—You can legitimately maintain general control over your company if you transfer shares of your business to trusts for the benefit of your heirs.

Trusts are contracts with a trustee that allow the person who created the trust (the business owner) to decide:

- Who benefits from the assets (i.e., shares of the business) the trust owns
- Who manages the trust assets (the business owner can be the manager)
- When distributions from the trust are made and under what circumstances
- Who decides how much to distribute

Not only can you as the grantor decide who will serve in all of these roles (i.e., trustee, manager of the assets, controller over distributions), but you also can reserve the right to replace these individuals at any time.

Trusts are not only tax-efficient, they also may help protect heirs from creditors' claims.

Bottom line: A business owner can generally retain the power to control a trust's investments, and therefore keep the ability to vote 100% of the company's shares even after transferring the economic benefits of ownership in the business.

1. **Restructure**—You can potentially recapitalize the business into voting and non-voting interests, with the goal of shifting economic interest and retaining controlling interests.

   In addition, you can reclassify the business interests into preferred and common ones, which would allow you to decide where income and remainder equity flow.[5]

[5] Strategy does not apply to S corporations.

Playing by the rules

The rules that make these strategies possible are the foundation of all tax-efficient estate planning in the United States: annual exclusions from gift tax, lifetime exclusions from gift, estate and generation-skipping transfer taxes, and deductions from annual taxes.

You may be able to reduce threats to your business from taxes, creditors and other risks without ceding all the control and benefits from the company to your heirs.

Given these tax-planning opportunities, here are nine techniques to consider:

1. Use the annual gift tax exclusion to move cash and assets that will appreciate significantly out of your estate to heirs

The annual gift tax exclusion can help business owners transfer interests in their companies to trusts for the benefit of their heirs over time.[6]

Every year, an individual can transfer—free of gift tax and to as many different recipients as desired— the annual gift tax exclusion amount. Indexed to inflation so that it slowly increases over the years, this amount is $18,000 for 2024. Therefore, in 2024, a married couple could transfer to each child $36,000 free of gift tax, or, if they had three children, a total of $108,000. If a couple makes gifts to three children every year for 10 years, they will have transferred over $1 million (excluding any potential appreciation) with no tax consequences whatsoever.

The value of the gift is the asset's value on the date of transfer. However, generally, the recipient's income tax basis is the donor's basis. It is therefore better, all else being equal, to give cash, unless you believe that a particular asset will appreciate significantly. If you give your child shares of stock worth $18,000 for which you paid $6,000, you have given that child an asset that, when sold, will be subject to capital gains tax on its value in excess of $6,000, not $18,000.

2. Gift shares in the business to heirs by using the gift tax exclusion and, perhaps, by paying the gift tax due

In addition to amounts covered by the annual exclusion, individuals also can transfer up to a total of $13.61 million in 2024 (adjusted annually for inflation) to anyone or to any trust during their lifetimes.[7]

As with annual exclusion gifts:

- These gifts can be made with any form of property, including shares in a business
- The value of the gift is the value on the date of transfer. However, the recipient's income tax basis is generally the donor's basis

Transfers in excess of the gift tax exclusion that are made by a donor, cumulatively, during his or her lifetime are subject to an effective federal gift tax at 28.6%.[8]

Lifetime gifts are more tax-efficient than gifts made at death, because:

- Any appreciation from the time of transfer until the donor's death is not part of the donor's estate (and therefore escapes estate taxes)
- The effective federal gift tax rate is lower than the effective federal estate tax rate (28.6% versus 40%)
- Lifetime gifts avoid state-level estate taxes (about half of all states have independent estate taxes), and, with the exception of Connecticut, no state imposes a gift tax

3. Gift shares in the business to your grandchildren (or to trusts for their benefit) using the generation-skipping transfer tax exemption

A transfer of wealth from a grandparent to a grandchild, while the child is alive, is subject to the gift tax as well as the generation-skipping transfer (GST) tax. However, the first $13.61 million given (adjusted annually for inflation) will not incur any gift tax liability because of the lifetime gift tax exclusion.

[6] The two other exclusions that are less relevant in this context are: (1) Education exclusion—An individual can pay for anyone's tuition expenses, as long as the payments are made directly to the educational institution. Those transfers can be made in addition to the $18,000 annual gifts; (2) Medical exclusion—Similar to the education exclusion, an individual can pay anyone's medical expenses, as long as the payments are made directly to the provider of the medical service, such as a doctor or hospital.

[7] The 2017 Tax Cuts and Jobs Act, signed into law on December 22, 2017, increased the lifetime exemption amounts effective January 1, 2018. The amounts are $13.61 million in 2024 for gift, estate and generation-skipping transfer taxes through December 31, 2025, at which time, these provisions will sunset and the exclusions/exemptions will revert to pre-2018 amounts.

[8] Connecticut is the only state with its own separate gift tax (with a $13.61 million exclusion in 2024).

The GST tax exemption is often used by grantors who create trusts for the benefit of multiple generations. Those trusts may last hundreds of years, and many, by their terms, could last forever, depending on the law of the state governing the trust. Once assets are in a flexible, well-drafted GST trust, the assets are, under current law, both outside the transfer tax system and usually unavailable to a creditor of any of the trust's beneficiaries, depending on the trust and state law.

4. For assets not transferred during life, some tax relief will be found in the estate tax exclusion. If that is not enough relief, other strategies may be necessary

If the fair market value of both your business and all your personal holdings is less than the estate tax exclusion amount —$13.61 million indexed for inflation—then you can leave it all to your heirs in your will, and no federal estate tax will be due.

If the value of your estate exceeds $13.61 million, the federal estate tax will be 40% of the value in excess of the $13.61 million. A number of states also impose an additional estate tax. The amount you can exclude from state estate taxes varies and may be much less than what you can transfer under current federal law.

Bill is quickly due

Estate taxes are generally due within nine months of the owner's death, and the impact on a business can be devastating. Not only does the family have to raise a large sum quickly, but doing so can create distractions for management precisely when its attention is needed to reassure employees, customers and suppliers, and fend off attacks from competitors.[9]

Borrow to pay estate taxes

One way to create liquidity to pay U.S. estate taxes is through what is known as a Graegin loan. Graegin loans can be complex transactions, but they also may provide much needed liquidity and considerable tax efficiency. The owner's estate borrows from a third party or a related party (e.g., family trust). The estate then deducts, as an administration cost, all future interest payments due on the loan, without having to adjust them for present values. This deduction reduces the estate for estate tax purposes.

To qualify for Graegin loan privileges, a loan must meet certain requirements. For example, the IRS must find that the family business is sufficiently illiquid; the loan must carry a fixed rate; and the estate cannot pre-pay or renegotiate the terms of the loan. Graegin loans are complex transactions that occur after the owner's death, and should be undertaken with the assistance of knowledgeable, experienced professionals.

Insurance helps pay estate tax

Some owners buy permanent insurance to create liquidity so their families can pay these estate taxes. That insurance is typically owned by a trust. Transfers are made to the trust, often up to the amount the owner can give away without incurring gift taxes. The trustee then uses these transferred funds to pay the premiums.

Because the policy is owned by a trust rather than the owner, the insurance proceeds upon the owner's death remain outside the owner's estate. Frequently, the trust will exchange the insurance proceeds for an interest in the business, so the estate has the cash to pay estate taxes and other expenses. Therefore, some interest in the business is owned by a tax-efficient, creditor-protected entity (i.e., a trust).

Insurance also is used when unrelated parties want to make sure that liquidity is available to buy out a deceased partner's interest in the business from his or her surviving spouse or family.

Note that it is wise to periodically review insurance policies to ensure their amounts are still adequate to meet potential needs and are performing as intended.

5. You can delay (but not avoid) the estate tax hit by giving the business first to your spouse, using the unlimited marital deduction

Transfers between spouses made during life or upon death have no gift or estate tax consequences whatsoever, as long as the recipient spouse is a U.S. citizen. This is true whether the gift is made outright or to a trust for the recipient spouse's benefit (provided the trust contains certain features that qualify the transfer for the marital deduction).

[9] There is a provision in federal law, 26 U.S. Code Section 6166, that allows extensions of five or 10 years to pay estate taxes when an estate consists largely of interests in a closely held business. It is important to consult with your legal and tax advisors to determine if your estate would qualify and if it would benefit your heirs to employ this approach.

The practical effect of the law is that married couples can put off paying the estate taxes due on their combined estates until the surviving spouse dies.

However, when the surviving spouse dies, anything in the couple's aggregate estate greater than $27.22 million is subject to federal estate tax at 40%. Note that if your business grows under your surviving spouse's stewardship, the estate taxes due on it will be that much greater.

6. Gifting or bequeathing your business to charity means there will be no gift or estate taxes due on it

Because of an unlimited charitable deduction, there are no gift or estate taxes on gifts to qualified charities—and that includes gifts to private family foundations as well as public charities.

U.S. owners often choose to leave their businesses to their family foundations when they are not leaving it to family members. However, it is important to know before choosing this option that the foundation must sell the business within five years (with a possible extension to 10 years if the business can show that a good faith effort to sell failed to find a buyer at a good price). Failure to sell within the allotted time results in significant excise taxes (200% of the value of the "excess business holding").

In addition, the foundation cannot sell the business interest to a family member who is a disqualified person without incurring an excise tax or penalties of "self-dealing."

An added boost from the markets?

Two tactics can help engaged taxpayers minimize transfer taxes. Both take advantage of the difference between interest rate assumptions and actual investment performance.

7. Transfer appreciation on assets, tax-free, through proper use of grantor retained annuity trusts (GRATs)

GRATs can help you make tax-free transfers of "excess appreciation" earned by an asset. This works by taking advantage of the potential difference between the rate at which the U.S. government assumes assets will appreciate (which is a single rate, set monthly, for all assets regardless of volatility and risk) and the actual rate of appreciation of a given asset over a set period of time.

If the actual rate of appreciation is greater than the government's assumed rate, the difference can pass to (or in trust for) your heirs without any transfer tax.

A GRAT is generally considered risk-free because the taxpayer suffers no economic loss if the asset transferred to the GRAT does not appreciate at a rate greater than the government-assumed rate.

8. Strategic sales can transfer appreciation on trust assets to a trust's beneficiaries without transfer tax

Taxpayers can sell assets, without transfer tax, to a trust they have created for the benefit of a spouse or other family member. In exchange, the trust issues a note, with an interest rate tied to prevailing rates. Because the assets are being sold rather than gifted, there is no transfer tax due, so long as the trust pays the taxpayer fair market value (which usually will require an appraisal).

If the asset appreciates at a rate greater than the interest rate on the note, that excess appreciation remains in the trust and is thus available for the benefit of future generations. There is no transfer tax on the excess.

Unlike a GRAT, this technique carries genuine economic risk: If the asset sold to the trust declines in value, the trust will have to deplete its assets and receive a gift from the taxpayer to satisfy the note at its full amount. Thus, the taxpayer would have used his or her gift exclusion—and perhaps GST exemption—for no gain, as the trust would be returning assets to the taxpayer.

9. For both tax and non-tax benefits from the long-term management and transfer of wealth, consider creating a holding entity, such as a family limited liability company (FLLC) or family limited partnership (FLP)

How this works: Together with other family members, you would enter into an agreement to achieve a business purpose (such as management efficiencies through the commingling of investments). You can retain some control over the underlying assets by having a managing member (or general partnership) interest. Such an agreement typically lasts for a specified term and imposes restrictions on who manages the assets owned by the entity.

Generally, it also identifies the terms under which units can be transferred or liquidated.

Why create this structure? There are at least three reasons:

- **Potential discounts to minimize transfer taxes**—FLLCs and FLPs are often used by individuals whose assets are worth more than the transfer tax exclusion amount. Units in the entity are less marketable because they are minority interests in an illiquid entity. They therefore tend to be discounted in assessed value when they are transferred
- **Income tax adjustment in basis of units at death**—Executors of estates that own units of FLLCs or FLPs (which are entities that can be classified as partnerships for income tax purposes) can receive the fair market value adjustment of their partnership units if the partnership has made a certain tax election
- **Non-tax benefits**—Aside from taxes, there can be significant benefits to creating these entities. Advantages include centralized management, continuity of ownership, creditor protection and the efficiencies afforded by pooled investment assets

It is important to keep in mind that the Internal Revenue Service generally scrutinizes FLLCs and FLPs closely. Great care must therefore be taken when establishing and maintaining an FLLC or FLP. You must have a strong business justification for creating one. Any discounts you take for transfer purposes must be reasonable and supported by a qualified appraisal. All business formalities must be strictly maintained; good recordkeeping is vital. Advice of counsel is critical.

What will work for you and your family?

Every business owner, family, company and stage of life is different. It is therefore imperative that careful, thoughtful and expert attention be given to identifying, implementing and adjusting the strategies and techniques that might best serve you.

J.P. Morgan has specialists in privately held businesses, fiduciary services and investments. We would be honored to help you and your legal, tax and business advisors craft a succession plan that honors the business you have built and transfers it so that it—and your future generations—may thrive.

Case Studies:

The scenarios on the following pages illustrate both cautionary and inspiring ways business owners confront a variety of risks.

CAUTIONARY

No exit: Siblings disagree about keeping or selling the business

BUSINESS	**Garment manufacturer**
ESTIMATED VALUE	$30 million
ANNUAL PROFITS	$5.5 million a year
OWNER PROFILE	Founder Peter Jay Tunick thought his business would never be sold. His eldest daughter worked hard to be the next chief executive officer. His eldest son became an artist but supported the family business. The younger two children were uninterested in the business, except as it funded their lifestyles.
CHALLENGE	After Mr. Tunick and his wife passed, a bitter family dispute erupted. The older two children wanted to keep the business; the younger pair wanted to sell. No buy-sell agreement was in place to resolve such differences. With no exit provided, the younger two felt trapped.
RESOLUTION	The siblings were helped to understand that it would not only be costly to litigate a buyout plan, but also disruptive and potentially ruinous to the business. Instead, the four agreed to this plan: **Transition to the second generation** • An independent firm was engaged to value minority shares in the business • A leveraged recapitalization allowed the company to take on only as much debt as the business's valuation and health indicated was appropriate and sustainable • The elder two children used the leverage to buy back stock from the disaffected siblings **Ongoing operations** • Independent board members were added to advise on distributions, compensation for the daughter as CEO and other matters that might place family members in a conflict of interest • Stock appreciation rights were granted to key, non-family employees to align their interests with the company (two senior executives, the chief operating officer and the chief financial officer) **Provisions for the future** • A new buy-sell agreement signed by the two remaining family members included an escape clause—in case, some day, they or future owners wanted a way out of the business

INSPIRING

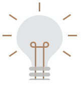
A true meritocracy: Each generation is welcome to join the family business—starting at the bottom

BUSINESS	**Distributor of plumbing supplies**
ESTIMATED VALUE	$150 million
ANNUAL PROFITS	$25 million a year
OWNER PROFILE	First to second generation–Founder Stanley Harrison successfully transferred his business in the 1970s equally to his two sons, then in their 30s. • Second to third generation–The two sons retired in the early 2000s and each transferred 70% of their shares to their children. Now in their 70s, the brothers rely on distributions from their remaining shares in the company for their living expenses • Third to fourth generation–The third generation numbers five children, four of whom are active in the business at various levels. The family is now training members of the fourth generation so they may one day successfully run the business
CHALLENGE	In the fourth generation, there is a total of eight family members, all of whom are interested in working in the business and having a shot at someday being the CEO.
STRATEGY	Company policy has long been set and integrated into the corporate culture: • **Active family members**–Family members are encouraged to join the business, but all must start at an entry level position and compensation. They then rotate through divisions and locations. Family members are fast-tracked, but not guaranteed positions if they fail. Each individual has to prove himself or herself at every level • **Non-active family members**–Only family members who are full-time, active employees can own voting shares of company stock. A plan is in place to repatriate the voting shares of those who leave • **Non-family members**–Constructive feedback is encouraged from non-family members about family members working as employees. Non-family members are able to rise to top levels of management. A limited number of key employees are able to buy non-voting shares of company stock
RESOLUTION	Helped by a fair and competitive meritocracy that values the skills and input of both family members and non-family employees, the business is thriving.

CAUTIONARY

Faulty planning, dire consequences: The importance of selecting an executor

BUSINESS	**Energy services firm**
ESTIMATED VALUE	$150 million
ANNUAL PROFITS	$19 million a year
OWNER PROFILE	Founder Herman Steiner had four children with his first wife, who died before him. He remarried, and his second wife had a strained relationship with his children, two of whom were active in the business.
CHALLENGE	Because of the conflict between his spouse and his children, Mr. Steiner chose his company's CEO, Gordon Green, to act as executor of his estate and trustee of the trust he created to hold the business for the benefit of his wife and children. Mr. Steiner wanted his wife to receive income from the trust during her life and the business to continue after his death with his children actively involved. However, Mr. Steiner did not make these intentions clear and binding in his trust or estate planning documents. After Mr. Steiner's death, Mr. Green had numerous potential conflicts of interest by virtue of his multiple roles as company CEO, executor of the estate, and trustee. Mr. Green created additional conflicts by setting up a deal that benefited him personally. Soon after Mr. Steiner's death, Mr. Green and the two children who were not active in the business negotiated the sale of the business to a private equity firm. As part of the transaction, Mr. Green negotiated a retention plan to keep and compensate key non-family employees—including himself. After the business sold, the two active family members lost their positions in the company.
RESOLUTION	After extensive and costly litigation involving all the parties, the courts held that, while Mr. Green's conflicts of interest were clear and abundant, Mr. Steiner as grantor had failed to stipulate in his trust documents that it was a priority to retain ownership of the business and have family members involved. Therefore, the court held that Mr. Green had sold the business in a prudent attempt to diversify the trust and properly fulfill his duty as a fiduciary.



INSPIRING

Restructuring to allow employees to carry on the business

OWNER PROFILE	**Regional construction firm**
ASSETS	$70 million
OPTIONS	$11 million a year
CHALLENGE	But, by the time Mr. and Mrs. Lawson were in their 60s and thinking about stepping back, both daughters admitted they did not want to take over the business. Fortunately, three of the Lawson's ablest senior managers were interested. Unfortunately, none had the capital to buy the Lawsons out.
STRATEGY	A partial employee stock ownership plan (ESOP) helped make everyone's hopes a reality: First, the company was converted to a C corporation from an S corporation. Then, the company borrowed $17 million from a bank and lent that money to a newly created ESOP. The ESOP used all $17 million to purchase 30% of the company's stock from Mr. and Mrs. Lawson, who continued to work and draw salaries. Going forward, the company will make tax-deductible contributions to the ESOP, which will use the cash to make payments on its loan. Each year, the company's contributions to the ESOP result in stock allocated to all employees' ESOP accounts.
RESOLUTION	Mr. and Mrs. Lawson can keep selling stock to the ESOP to diminish their stake in the company. Or they can maintain majority ownership to preserve their family's future options. The Lawsons were eligible for a Section 1042 exchange, which would allow them to defer their long-term capital gains taxes on the sale of their stock to the business by investing the proceeds in qualified replacement property securities. If the Lawsons hold these securities until their respective deaths, they will be eligible for a step-up in basis and may never pay long-term capital gains on their stock sales. Either way, Mr. and Mrs. Lawson would be well advised to (1) invest their liquid assets for potential growth; (2) oversee their company's management to protect their remaining ownership interests; (3) engage in estate planning to time and make tax-efficient the transfer of their assets to their daughters; and (4) consider purchasing life insurance to cover any estate taxes that may be due when their estate passes to their daughters.

Take charge of your future

Essential documents checklist*

- [ ] Will
- [ ] Shareholders’ agreement (voting and buy/sell)
- [ ] Life insurance policies
- [ ] Employment agreements
- [ ] Revocable/Irrevocable trust(s)
- [ ] Employee benefits plans
- [ ] Beneficiary designations on deferred income assets
- [ ] Property and casualty insurance policies (for directors and officers)
- [ ] Family tree
- [ ] Other trusts of which family members are grantors, trustees or beneficiaries
- [ ] Healthcare proxy
- [ ] Living will
- [ ] HIPAA form (allows disclosure of medical information)
- [ ] Powers of attorney

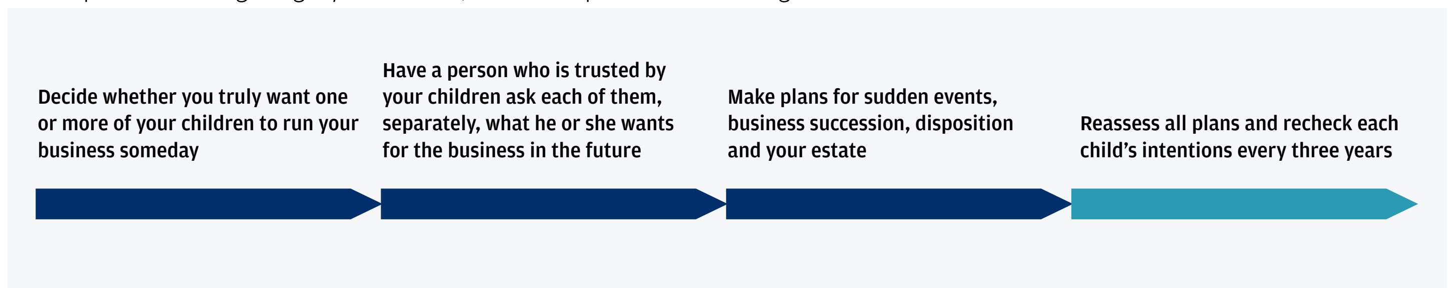
* The list is provided for illustrative purposes only and is subject to change.

Key lessons

- If you want your children to run the business someday, you have to plan as soon as possible and keep adjusting those plans as circumstances, and possibly laws, evolve
- U.S. estate taxes create a significant hurdle for most business succession plans. But if you plan properly, your heirs can surmount this hurdle
- Psychological factors matter. Acknowledge, honor and factor into plans honest assessments of all key players' perspectives. This includes the emotional realities of the business founder, his/her spouse, each of the children (active in the business or not), and key employees
- Time and resources devoted to properly documenting business success plans are well spent. Objective professional advice is required

Action plans

As complex as creating a legacy business is, the action plan is rather straightforward:



And if, after an honest assessment or at some point in the future, you or your children answer "no" to keeping the business in the family, another world of possibilities will be available.

The Advice Lab at J.P. Morgan

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STEVEN L. FAULKNER
Managing Director, Private Business Advisory

Steven L. Faulkner is a Managing Director and Head of Private Business Advisory in J.P. Morgan Private Bank's Advice Lab. Mr. Faulkner is responsible for developing content and solutions for business owners on issues such as mergers and acquisitions, corporate governance, pre-transaction planning and maintaining a legacy business over multiple generations.

Mr. Faulkner was formerly responsible for managing a national team of more than 80 investment management, real estate and business valuation professionals. Mr. Faulkner has extensive experience analyzing, reviewing, advising and transacting closely held businesses, limited partnerships and private equity investments. Mr. Faulkner presently serves on the boards of directors of several closely held companies.

Prior to joining J.P. Morgan in 1998, Mr. Faulkner was a practicing attorney and advised a range of businesses from multinational corporations to small family-owned businesses in mergers and acquisitions, succession planning and litigation of closely held company issues. Mr. Faulkner is a graduate of Michigan State University (B.A.) and The Ohio State University (M.P.A., J.D.).

Mr. Faulkner has been a featured presenter at the O.C.C. Large Bank Field Examiners Seminar, multiple Delaware Bankers Association Trust Conferences and several National Trust Closely Held Business Association annual meetings, as well as other conferences and associations. Mr. Faulkner regularly presents at legal and accounting firm continuing education events and private equity symposiums. Mr. Faulkner has been quoted in *The Wall Street Journal, Financial Times*, Dow Jones, *Barron's*, Bankrate.com, *Kiplinger* and *Crain's Business*. In addition, Mr. Faulkner was previously an adjunct professor for the Butler University Honors Program.

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