## MEET THE PANELISTS

### KEVIN TULLY, CPA

**Tax Shareholder,
Teal, Becker & Chiaramonte, CPAs, P.C.**

Kevin Tully is a graduate of Siena College and the University at Albany with over 35 years of experience providing TBC's corporate and individual clients with tax, accounting, and advisory services, including business succession strategies. Individual income, estate and gift taxes represent special areas of concentration. His client base includes professional organizations, retailers, wholesalers, distributors, manufacturers, contractors, and real estate developers among others.

Prior to joining TBC, Kevin taught for a brief time in the Glens Falls School District. The former teacher in Kevin enables him to impart his technical knowledge to both clients and the staff. This includes monitoring changes resulting from new tax legislation and guiding the staff in its implementation. Kevin is a board member for Chemung Canal Trust Company. He is a current board member for civic organizations including the Fast Break Fund, Inc. and Living Resources Certified Home Health Agency and he is a former board member with the Saratoga Children's Museum.



### MARIO J. PAPA

**Partner, Hodgson Russ LLP**

Mario concentrates his practice in corporation taxation and corporation law, including mergers, acquisitions, reorganizations, financing corporate transactions, estate planning, trusts, and probate law. Mario has extensive experience counseling closely held businesses, including structuring acquisitions and sales and complex business transactions. Through his representation of closely held businesses, Mario has developed a niche practice in counseling owners of closely held and family businesses in succession planning, including restructuring and financing corporate entities and the integration of succession plans with business owners' overall estate plans.

Mario's estate planning practice consists of counseling wealthy individuals in estate planning and administration, including the creation of private foundations, charitable remainder and charitable lead trusts, family limited partnerships, and trusts.

Mario is the former city judge of the City of Gloversville (1984-92). Prior to practicing law in upstate New York, he worked with international certified public accounting firm Ernst and Young in New York City as a tax consultant.



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# SUCCESSION PLANNING

The *Albany Business Review* hosted two experts to discuss succession planning. The discussion was moderated by Thomas Begley, dean of the Lally School of Management at Rensselaer Polytechnic Institute.

***We are talking today about business succession planning in family-owned firms. Could each of you take a minute to describe an example of a succession plan that worked very well, and why it worked so well?***

***Kevin Tully:*** We had a particular situation where it was a larger family business. The owner had enough foresight to know that his children could not run it on their own, so he put a very good management team in place.

He restructured how it was owned in such a way that, if something should happen to him suddenly, it could carry on. There was an extraordinary amount of assets, but also debt. The owner did die suddenly and unexpectedly, and banks were very concerned. But they were able to continue the business without missing a beat because the management team was in place.

It was a mechanism where the team could get ownership and, in fact, took on a great deal of personal ownership in the business. They were able to carry on so that the family and the next generation are provided for, but they have expert management in place that still carries on today.

***When the owner established the management team outside of the family, how did the family respond to that?***

***Tully:*** I think it would be probably oversimplifying to say that they embraced it all the way. But through time and conversations, and through their own understanding of their own abilities and inabilities, I think they came to realize this was the best thing for them. In the end it was accepted, but it wasn't without its struggles.

***Mario Papa:*** I think the real problem with a succession plan or a family plan is that not everyone is interested in the business, and the owners would probably want to equalize as best as possible with other family members. You may have one child that runs the business and is capable of running the business. Obviously, the key to a good succession plan is the person you put in has to be capable.

I've done succession plans that have taken two, three years to put through when you get into the more sophisticated ones. But this was a very simple one that worked really well.

There was a client that had three children. Two children were in the business and one child was not. One child was a professional, living down south. This was a business that involved real estate and an operating company. So we moved the operating company over to the children through some trusts, and the owner maintained control for awhile over the voting shares, non-voting shares. We put the real estate in the trust, and the money coming out of the trust equalized with the daughter, who was not in the business. The plan is still going on now, and the voting shares are now being moved over to the children because they're doing well.

It worked out well because we had this real estate asset for equalization, and there was rent coming from the operating company to the real estate business, which the daughter would draw off. The other two children are running the company and they're reaping the benefits from that, and the parents are now getting money through a mechanism that we set up because we did a part sale, part gift to them of the shares.

***What is a trust and how did it work in this instance?***

***Papa:*** A trust is a three-party instrument. You have the grantor, the trustee and the beneficiary. A trust can be revocable or irrevocable. If you want to do any discount valuation planning and move stuff out of an estate, you use an irrevocable trust.

A trust does a lot of things. Number one, it protects the beneficiaries of the trust from creditors. So, there's asset protection. It protects them from divorce, because it's just not an asset that's in an estate of one who's being divorced, or from being impacted by bankruptcy or third-party claims.

The client I talked about earlier had step-out ages in the trust, where when the child got older they got a third, a third, a third of the LLCs that were in the trust that held the property, because we were doing insulation within the trust from other assets, putting assets in an LLC to protect the other assets in the trust.

The nice thing about the step-out, like a third at age 35, a third at 40, a third at 45, however you want to set it up, the child does get a piece. And then, if they start their own business, the one not in the business in this example starts her own business, or if something goes wrong, they get another a bite of the apple.

***Papa:*** Trusts are important, even in business succession and overall estate planning. Let's assume that you leave your shares of stock in a family business by will to son A or daughter A, and there's son B, C, daughter A, B, C, whatever, and you got to probate the will. You have to receive from the surrogate the right to transfer the stock.

This means that the transfer of the shares is held up. The business can't be run because the father is dead, or the mother is dead, or they are both dead. So, you have to move the court for preliminary letters of administration to get the power of the court granted to you to run the business. This takes time and if you've got a time-sensitive business, you could be running down the tubes.

***Tully:*** That successful transition of the business that I described earlier had those kinds of trusts in place. The business did not have to stop for a minute.

***Papa:*** Exactly. If it's an irrevocable trust, there is no probate and it just keeps operating. You deal with the trustee, and the trustee then forms the board of directors or whatever, and you run the company. You should really think through whether you're going to use a will or a trust or whatever.

***Tully:*** I think the ones that go wrong are the ones where they make a structure where the kids do inherit a business equally, and nobody's clearly in charge. Businesses change. The thing that you're doing now may not work in the future and you need to be able to react to those changes. If you're paralyzed with the leadership in the businesses, you can't conduct business and it will fade away. That's happened many, many times.

***What are some of the dynamics that tend to occur, when, say, you have two children, one of whom is highly competent and the other one is not, but both of them are interested in the business?***

***Tully:*** If proper planning hasn't occurred and the parent is no longer there to officiate, that's where you have problems that can be difficult to resolve. If the business is going to survive, somebody is going to have to take control over it, and that doesn't happen easily without a lot of angst and trouble between the parties.

***Papa:*** One of the real problems that I have bumped into, especially in the society today, is that you have split families. I'm doing one right now where the father has a son who is not a very nice guy, and the stepson is a good guy. So, we're doing a succession plan that's passing the business on to the stepson. The owner also had daughters and there was the feeling of animosity because, A, it's going to the stepson; and B, his real children are getting the "drippings of the pan", as I heard in the meeting. It gets really, really hairy. That's where you have got to try and equalize as best you can.

Here's a different example: The family wasn't a blended one, and we had to transfer the business to sons. And we had the transfer as equalization. We had the business valued, and we had the transfer of the stocks and bonds and real estate to the daughters.

So, the boys are running the business, having a grand old time running the business, and the girls are really upset because the boys got all this upside. Well, guess what? The business went bankrupt. So, those two boys who got the business, they were out of business. They went bankrupt. One of the boys had to go to the sister to borrow money from the portfolio that the father left to equalize in order to start a new little business to keep his life going.

***How often would you find an owner passing on and no succession plan developed?***

***Tully:*** Usually, something has been done. It's almost like a definitional thing, to have no succession plan at all. I never had a person die who didn't have a will, but I think there are all levels of preparedness. You can do a halfhearted job or you can do a good job. Every situation is distinct depending on the types of assets that the family owns, the skills in the family.

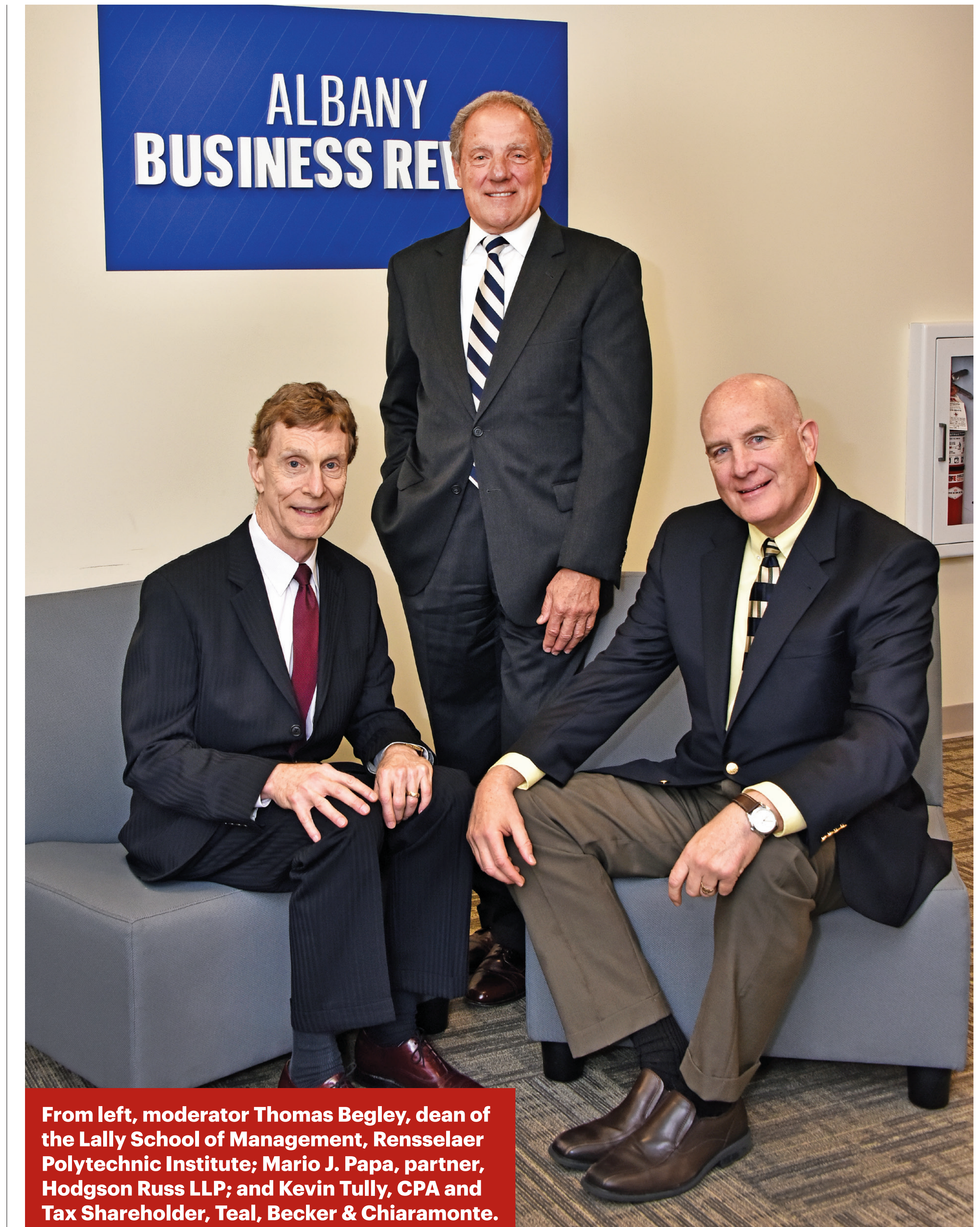
***Papa:*** When you start peeling the onion back, when you have a successful business, there are so many ancillary problems underneath. You have to go to the bank. You have got to disclose this thing to the bank. You have guarantees of debt. The father wants to get off the guarantee. The son says, are you crazy? I'm not going to get on $10 million of guarantees. It goes on and on and on.

***Tully:*** I often think the willingness of the next generation to take on guarantee is a great litmus test of commitment. It really brings home to them that they're getting the benefits as well as the complications of the business.

***Do you ever feel tempted to bring in a psychologist when you're dealing with families?***

***Tully:*** I have clients that have done it.

***Papa:*** We brought in family counselors. The one we're doing now, there's a family counselor who's been working with them for six years. But there's a problem: The old guy doesn't want to let go, so how are you going to have a succession plan? He's right at the top. They all want a succession plan, but he's been sitting in that corner office for sometime.




**From left, moderator Thomas Begley, dean of the Lally School of Management, Rensselaer Polytechnic Institute; Mario J. Papa, partner, Hodgson Russ LLP; and Kevin Tully, CPA and Tax Shareholder, Teal, Becker & Chiaramonte.**

DONNA ABBOTT-VLAHOS


From left: Kevin Tully, Thomas Begley and Mario J. Papa.

DONNA ABBOTT-VLAHOS

***Do you often run into situations where the business owner finds it impossible to let go?***

***Tully:*** Yeah. I think that's a very difficult hurdle to overcome from the perspective of a person like an accountant or a lawyer that's trying to do some planning. They want to give it away but still control it. You have to work on them and tell them what can go wrong, but ultimately it's their decision.

***How do you compensate key non-family employees that have been with the business for years?***

***Tully:*** Great variations can occur there. Sometimes the actual structure of the business affects that, because sometimes having an employee own it, is pretty tax inefficient.

If you can talk to the key employee and say, listen, if you had ownership of this company what would you hope to get? An opportunity to participate in profits? Well, we can simulate that. That usually is much easier to accomplish. As long as that is all the person is looking for, you can get over the hump.

***Papa:*** We do what is called a phantom equity plan, which is not real equity. It's an account where the key employee will receive an award of a particular number of shares in a company. They don't get the actual shares, but they're paid out in the future depending upon triggering events – death, retirement, sale of a business. I've even done them where, if there is a sale of the business, they are converted into real equity and they get a piece of the action on the sale. So, if the sale is $10 million and he's got 10 percent, that's a nice payday.

You can also put in a special account with that called a contribution account, so that when the owners take out the dividend, it goes into an account for the key employee. They are participating, but they don't have any vote. They don't have any real shares. And they get a nice little retirement type of benefit set up through the contribution account so that on retirement they get paid out. There's some tax efficiencies there for the company, too.

***Can you talk about the possible inefficiency or valuation that might occur when you're trying to sell a business versus pass it on to your children?***

***Tully:*** If I own a business and I take it to the marketplace, there are some fairly standard ways on which the business can be valued. However, if for some reason the business is of strategic importance to a competitor, they may pay you money that doesn't necessarily make sense relative to what you built.

Certainly, when it comes to transferring a business to your children, you're not going to get that money, or if you're going to transfer the business to a group of employees, you're certainly not going to get that money. A lot has to do with the goal of this particular business owner. Does the owner want to maximize every dollar and leave those dollars to the children instead of the business, or do they want to see that business carry on?

***How do you get to the selling price?***

***Papa:*** If you're going to sit down across the table with somebody and negotiate an arm's length sale, you have to have a benchmark. You have to know what your company's worth or you're going to be bidding against yourself or leaving money on the table. You need a real-time valuation if you're going to do a business succession plan and you're going to be gifting to your children or selling it to your children.

The point of the business succession plan is more than just giving shares to family members or key employees. It's to integrate into an estate plan to mitigate and reduce the estate taxes that you have to pay on all of your hard work in developing this business.

***How do you establish the value of a business?***

***Tully:*** The typical way I seek to value a business is based on some sort of a multiple of EBITDA, but some businesses don't lend to that kind of valuation. Sometimes the valuations are the individual assets within the business. But the most typical is some sort of a multiple of EBITDA.

***Papa:*** There are situations where another company says, we want your niche, we want your patents, we want your intangibles. I've seen those numbers blow right through the ceiling and past the EBITDA number, or a value based upon earnings or numerous ways you value, because you've got something they want.

***What advice on minimizing estate taxes would you give to an owner who's thinking about passing along their business?***

***Tully:*** The hope is that you can find a way to pass the business to the next generation at a value that does not reflect what it will be worth in the future. Certainly we hope it will be worth more in the future, but we have a client now that is in a particular kind of business that is declining because of the nature of the internet and technology. Dad owns this business, but we're not giving it to the son because we feel it's worth more now than it will be in the future. It's the opposite of what you would want to do.

But assuming that's not the case, you feel that you have all kinds of opportunities for growth into the future. If you can give that business away now to a child, you can do it in such a way where you make use of discounting that's allowed under the law. But the fact is, if I give you 100 percent of a company, you control it. If I give you five percent of the company, you don't.

That means there's a discount associated with that smaller piece. If we can make use of those discounts as a way to transfer businesses that have a lower value than it would otherwise transfer them, hopefully the growth occurs while it's in the hands of the child.

What makes all this planning so important is the sheer rate of the estate tax. The ones I worry about most are the people that are involved in the real estate business, where there's potential liquidity, but it's not instantaneous – where you could really owe an estate tax of significant size that can force you to sell off the whole business.

***In broad terms, where does legal advice play the greatest role in the succession plan?***



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***Papa:*** Throughout. I would indicate to the client, whether he's starting a business or he's incorporating, that the client be mindful of success and be mindful of planning for business succession now. Not that they're, in fact, going to do it, because there's not much to transfer, but they should set those corporate documents up now so that once the business grows, the structure is in place. No legal documents, no fancy buy-sells or trusts or anything like that, just structure the actual entity so that it can be moved around easily.

***Tully:*** There's a certain personality type of entrepreneurs we should be aware of. A person that starts a business is very unlikely to say, that's all I want to ever do. They have a thing of wanting to start another business.

When our client says, I'm thinking of doing something new, I think one of the first things we as accountants should ask is, do you need to own this or should the children own this? Yes, it's just an idea right now, but can we get the children involved right out of the gate? That can be one of the simplest and the most powerful things if it happens to be a successful business.

***Papa:*** Years ago I had a client that had a business and was doing very well, and he's buying another business out of bankruptcy. When you buy out of bankruptcy, you're not really sure what you're going to be getting.

But this was a business that had hard assets – in-the-ground type of assets. I said, you're doing a business succession plan for the big business and this one is a home run. When you buy it out, you're going to be buying it out at X dollars. Get it out of your estate immediately and get it into your family trust, so that the appreciation going forward will be out of your estate, and then you've got nice money coming in to take care of your family.

They didn't do that. The business grew to multi-millions of dollars. All the while, the business sat in the guy's estate, and he died and got nailed. Had he made that move in the beginning, Uncle Sam would have had his fingers out of the man's pocket.

***What should successors be most concerned with as the business is being turned over to them?***

***Papa:*** Carrying the debt. If everything was given to me, it might make it a lot easier. But if there was a part sale and part gift, and I bought part of it and had to pay my father or my mother for the shares that I got, maybe at a discount, but still I have to pay for it to maintain their lifestyle.

Worse yet, I have a relative that's in the business and the company redeems the relative out. In other words, the relative sells his shares to the company and gets his retirement, and now I own the business and I may be paying my mother, my father, and my relative. Is the cash flow there? It can get really dicey.

***When should an owner start succession planning?***

***Tully:*** I've had some people that have been very proactive about doing it and it's been very successful for them. But certainly early on in the process there should be at least the planning documents, like a will, that will speak to that stuff. You have got to have continuation of the business, even if it goes right through your will.

***How often should you review your plan?***

***Papa:*** We like to have our clients meet with us every two years or three years, to review what has changed. I think it would be the same with a business succession plan – because son A is not stepping up to the plate or doing things he shouldn't be doing. Son B, who is younger, is flying and d oing well. Daughter is a great marketer and we want to give her some shares. Especially, it should be reviewed when circumstances change in the family.

pay for it out of the earnings. The spouse, wife, husband, doesn't matter, is getting out of the redemption – they're getting paid through the company the value of the shares and have something to live on when the spouse is dead.

***Tully:*** If it was a bigger business, the takeoff on that would be ESOP, or employee stock option plan. ESOP is a method by which the owners, as a collective group, can own the company in a pretty tax-efficient way. There are great benefits to the owner selling to the ESOP and there are nice benefits to the plan itself in paying off any debt. It has to be a larger business that can sustain a lot of administrative costs that go with it.

***Are there issues that we didn't cover that we should have?***

***Papa:*** Sometimes us lawyers make things more complicated than they should be. Business succession planning is a dynamic. It constantly changes. You can do little steps. You can make annual exclusion gifts every year and double the gift with spouse's consent. You can get discounts on those and move stuff out a little at a time.

You can enter into a simple buy-sell agreement where there's a redemption or life insurance there to take out the redeemed stock that goes into the estate of the stem-winder, and kids got a couple shares. You should really take little steps and see if you are comfortable with it, see how the children or the next generation is doing, and then maybe you can take a big step when you are older.

***Tully:*** You need to make progress. To me, the best way to make any progress at all is forget about taxes. Don't let that twist you in a knot. Just say, if there was no such thing as taxes and I could do what I want, what would I do? ■

> *"The point of the business succession plan is more than just giving shares to family members or key employees. It's to integrate into an estate plan to mitigate and reduce the estate taxes that you have to pay on all of your hard work in developing this business."*
>
> **MARIO J. PAPA,** Partner at Hodgson Russ LLP.

***What happens when there are no family members involved and you're trying to figure out what to do with the business?***

***Papa:*** We are doing one right now exactly like that: successful business, no children, and enough money on the outside to take care of the spouse. So, we are getting some shares down to two key employees.

We're forming a buy-sell agreement, shareholder agreement. The owner of the shares will get the two key people a small number of shares, maybe 10 shares each out of 100, leaving the owner with 80. Then we enter into a buy-sell agreement. If the owner retires, becomes disabled or dies, his shares will be redeemed by the company and the company buys them back.

The shares are then cancelled and the two guys own it 100 percent. It's the basic concept of how to

TRANSCRIPT LIGHTLY EDITED FOR SPACE AND CLARITY.

*Thank you to our participants*