The Succession Plan Information Summary has two parts –

1) Information about corporate or business entities, and

2) Information about estate planning that gives more detail about the legal concepts you will need to understand to create a succession plan.
Corporate & Estate planning

There are two different areas of the law that impact succession planning: **Corporate** and **Estate Planning**.

This document provides a more in-depth summary of the Corporate Form and Estate Planning law considerations and definitions when thinking about creating a succession plan.

Section I. will provide the **Corporate Form** Summary, and Section II. will cover **Estate Planning** considerations and definitions.
Section I. Corporate Form Summary

1. Sole Proprietor
A sole proprietorship is the simplest business form. An example would be a small online retailer. Importantly, the law does not distinguish a sole proprietorship separately from the owner because the owner is the person who (1) is the owner of all the property and inventory; (2) is entitled to all of the business’s profits; and (3) is responsible for the business’s losses and debts. Sole proprietorships often have fictitious names, “doing business as” (DBA), or trade names.

   a. Ownership/Equity-- A single person owns a sole proprietorship.
   b. Management-- The sole proprietorship is managed by the owner or usually a close family member or spouse. There are no formal or official titles, but the individuals managing the business may use traditional titles like President, Manager, or CEO to describe themselves.
   c. Governing Documents-- Documents typical for a sole proprietor include: business licenses, titles for property or inventory, and any business accounts. Implementation of a succession plan for a sole proprietorship often includes a simple, written instrument explaining the succession plan, a will or trust, or could include incorporation or formation of another entity listed here.
2. Partnership
A partnership is two or more individuals who agree to work together to advance their mutual business interests for profit. Importantly, the law creates a partnership solely on the business relationship of the parties—no filings are required to find yourself in a partnership. An example would be a family venture with spouses or siblings that is otherwise unincorporated. This business arrangement can be established unknowingly through informal actions or with knowledge through a written partnership agreement. A written partnership agreement is best because it knowingly and formally establishes the partnership between the individuals.

a. Ownership/Equity-- The owners of a partnership are the individuals involved in the business relationship. The partners own the business equally unless otherwise agreed.

b. Management-- A partnership is managed by the individuals equally. Each individual can legally bind the other partners and the business through his or her actions. Each partner assumes the responsibilities and liabilities of the business.

c. Governing Documents-- An unincorporated partnership does not have any required documents but should have a written partnership agreement. This partnership agreement will establish the roles, responsibilities, and powers of each partner. The partnership agreement can be as simple or as complicated as the partners want, and often the partnership agreement includes agreements for succession planning.
3. LLC (Limited Liability Corporation)

LLCs are often referred to as a “hybrid entity” because they are governed by state laws, like a corporation, but the owners can greatly amend or add onto the state legal requirements through an agreement among the owners, like a partnership. LLC examples would include local businesses such as a printer, a plumbing company, or a restaurant.

a. Ownership/Equity-- The owners of an LLC are called “Members.” Typically, a Member’s ownership interest is represented as a percentage, often called a “Membership Interest,” or the ownership can be referred to in terms of “Units.” Units act like traditional corporation shares and represent the percentage of ownership in the business. So, for example, Amanda and Betty could represent their ownership in an LLC as each having a 50% Membership Interest, or if they each own 100 units, and there are no other owners, then they each have a 50% ownership of the outstanding LLC Units.

b. Management-- LLC management is described as either: (1) Member-Managed or (2) Manager-Managed. Both forms are common. Remember, however, that the ownership continues to be in the hands of the Members.

- **Member-Managed:** Controlled by Members. Members are both the owners and the everyday decision makers for the business. An example of a Member-Managed LLC is a business where the Member is the sole owner and does not have or does not anticipate having another person helping manage the everyday decisions of the business.

- **Manager-Managed:** Controlled by a “Manager.” Manager-Managed LLC’s ownership remains vested in the Members, but the power to control the business is delegated to a person or persons who are the Manager(s). The person deemed the Manager in legal control of a Manager-Managed LLC can, but need not, be a Member. Importantly, under this management structure, Members do not have day-to-day control.
4. Corporations
Corporations are a very formal entity type mostly governed by state law. Examples include a medium to larger sized manufacturing company or start-up tech company.

a. **Ownership/Equity**-- The owners of a corporation are called “Shareholders” and each Shareholder’s ownership is represented by “Shares” or “Stock.” Shares or Stock are instruments that represent a Shareholder’s ownership in the corporation, but it is not necessary to have or issue these instruments.

b. **Management**-- A corporation is managed by the board of directors (the “Board”). The Board then delegates its authority regarding the day-to-day decisions to a group of management referred to as “officers.” The corporation’s management style lends itself well to businesses that require having specialized roles, where one person is required to dedicate her time to a specific area of the business (for example, the Chief Financial Officer, or “CFO” would focus on the financial aspects of the business). One individual can be a board member, an officer, and have an ownership interest in the business as a shareholder.

- **Board of Directors:** The Board is elected by the Shareholders each year and each person is a “Board Member” or “Director.” The Board is entrusted with the welfare of the corporation—in fact, the individuals on the board owe legal fiduciary duties to the corporation—and with these duties oversees the “big picture” of the corporation. Examples of Board decisions are purchasing or selling major assets, issuing shares or stock to potential new shareholders, and appointing officers of the corporation.
- **Officers**: The officers are appointed by the Board and serve at the Board's pleasure. The officers act under the general direction of the Board and are responsible for the everyday activities. Traditional officer titles are President or CEO, Vice-President, Treasurer or CFO, or Secretary. Officer roles and responsibilities are usually more fully outlined in the corporation's bylaws, but importantly, officers have the authority to bind the corporation in contract. Examples of an officer acting at the Board's direction is when the Board decides to move to a larger location, the CEO or President will work towards achieving the Board's goal and sign any necessary documents.

c. **Governing Documents**-- Documents required for a corporation include the Articles of Incorporation and Bylaws. Articles of Incorporation are filed with the Secretary of State to form the corporation. The Articles of Incorporation provide the foundation and initial framework for the corporation, such as the initial board members, the rights and responsibility for shareholders based on classes of stock, and how the initial Bylaws will be adopted. The Articles of Incorporation likely have crucial terms for succession planning, so it is a vitally important document! The Bylaws are the internal operating manual for the corporation. The Bylaws can be simple or complex and will govern how the corporation places individuals into their roles (how board members are elected, how officers are selected, and how long the individuals serve in those roles, for example). The Bylaws are adopted by the Board but not filed with any state agency. Bylaws explain transfer of management powers (Board and officer roles), and they often explain rights and responsibilities regarding transfer of ownership (share issuance or transfer).
Definitions

**Partnership Agreement**: The agreement among partners on the roles, responsibilities, and powers of each partner for a partnership.

**Articles of Incorporation**: The documents filed with the Secretary of State that form a corporation, and typically includes the rights and responsibilities for shareholders.

**Bylaws**: The documents that provide the rules, decision making process, and internal governance structure for a corporation. Bylaws explain management roles, responsibilities, and transfer, and sometimes include rights and responsibilities for shareholders.

**Shareholders**: The individuals who own part of a corporation. Ownership may, but need not, be represented by stock certificates.

**Board of Directors**: The individuals who make the strategic or “large picture” decisions for the corporation.

**Officers**: Officers are the individuals who make the day-to-day decisions for a corporation, often implementing the Board of Director’s decisions.

**Certificate of Formation**: The document filed with the Secretary of State to form an LLC. Could include provisions about ownership or management.

**LLC Agreement or Operating Agreement**: An LLC Agreement or Operating Agreement is the internal document that provides the governance structure for an LLC, including the Members’ ownership rights.

**Members**: Members are the owners of an LLC. Member ownership can be reflected as a percentage or by “Units.” In some cases, the Members are also the day-to-day decision makers.

**Managers**: Managers are the day-to-day decision makers for an LLC.
Definitions (cont.)

**Registered Agent:** Is an individual or third-party company that is designated to receive service of process (lawsuits), notices from the Secretary of State, and any notices from government agencies. The registered agent also receives any notices sent to the company from private third parties trying to contact the company.

**WA Annual Report:** The Annual Report is a yearly filing with the Secretary of State to confirm or update the company’s information. The information requested is the registered agent’s information, the business and mailing address of the company, and the owners and management of the company.

**Business License:** The business license is provided by the state and your local municipality. Most businesses require both a state and local business license. The business license allows your company to operate its business.

**Shareholders’ Agreement:** An agreement among shareholders governing their respective rights, which could include, among other things, an agreement on what directors to vote for now or in the future, and the rights and obligations for transferring share ownership at death, divorce, or some other event.

**Buy-Sell Agreement:** Similar to a Shareholders’ Agreement but is a broader instrument used by owners of any entity type. Unlike the Shareholders’ Agreement, typically only pertains to rights and obligations for transfer of ownership.
I. Considerations for transfers

Who
The first step in succession planning is identifying the individuals to whom you plan to eventually transfer the business interest. This could include children and spouses of children. This decision should also take into account different roles family members may play in the business and how to equalize for those roles and interests.

What
Once the individuals are identified, the next step is to determine what interest is to be transferred to the beneficiary. Consideration should be given to the amount that is transferred and the class of interest, for example, a voting or non-voting interest, that is transferred. Going through the corporate form analysis will allow you to better determine the "what."

When
Once you know what is going to be transferred, the next step is to determine if these transfers should be made during life or at death. There are benefits and drawbacks associated with each that should be considered. Below is a noncomprehensive list of some of the various ways to make transfers and the associated benefits and drawbacks.

II. Lifetime Gift

An individual may transfer an interest during his or her lifetime to a recipient. Once a gift is made, the individual will no longer have any control over the interest transferred and will have no economic right to the units transferred. An appraisal will be needed to value the interest transferred, and to the extent a minority interest is transferred, a discount may be applied. To the extent a transfer to a single recipient exceeds $15,000, a lifetime gift will reduce an individual's federal gift and estate tax exemption amount. A gift will also need to be reported on Form 709 by April 15th of the following year of the transfer.

The benefits to lifetime gifting is that it lowers the amount of a taxable estate and allows for a younger generation to learn about the business. The drawbacks to lifetime gifting include loss of control, the loss of income, and the loss of a step-up in basis, which increases the capital gains taxes that will have to be paid if the property is subsequently sold. A recipient of a gift receives a carry-over basis, meaning the recipient takes the donor's basis in the property, which could be troublesome if there is a significant amount of built-in gain with respect to the transferred interest.
Necessary Documents
To effectuate a lifetime gift, the following documents may be required: (i) an appraisal to value the gift as the date of the transfer, especially if a discount is applied; (ii) documentation of the gift via the corporate structure—for example, an assignment and consent resolution may be required to effectuate and document the gift; and (iii) Form 709 to file.

III. Lifetime Sale

A sale of an interest can be made during life to the intended transferee. An appraisal will be needed to value the interest that is subject to sale. The sale can be structured so the transferee purchases his or her interest outright or through debt. An individual can finance the sale on behalf of the transferee. For the loan to be respected, interest will need to be charged at a rate published by the IRS. The benefit of a family loan is that it provides cash to the family member who is selling the business. Note though, an individual will have to pay taxes on the income from the sale and on any interest payments received.

Necessary Documents
To effectuate a lifetime gift, the following documents may be required: (i) an appraisal to value the gift as the date of the transfer, especially if a discount is applied; (ii) a promissory note documenting the loan; (iii) a purchase and sale agreement; (iv) a deed of trust to secure the promissory note; and (v) documentation of the sale via the corporate structure (for example, an assignment and consent resolution may be required to effectuate and document the gift).

IV. Other Considerations

With respect to transfers made during life, either by sale or gift, it is important to confirm that such transfers are in accordance with the terms of the governing documents. Oftentimes, governing documents can contain transfer restrictions with respect to who can hold an interest in the company. The governing document may also contain a right of first refusal, which would require an offer to sell the company or other members before the interest can be sold. If you are in a position where you are creating a new entity or can amend an agreement, before any transfers are made, consideration should be given to whether any limitations and restrictions should be incorporated into the governing documents.

Finally, the different estate, gift, and income tax consequences should be considered and weighed with respect to the transferor and transferee to make sure that transfers are made in a manner that is tax-efficient and cost-effective given the effect the different types of transfers have on basis and income.
V. Transfer at Death

If no action is taken during life, the transferred units will pass at death in accordance with the terms of estate planning documents, or if none, state law. At death, the person who dies is called a “decedent.” The entire value of the business interest held by the decedent will be included in the decedent’s estate for purposes of state and federal estate tax. Depending on the type of business and the assets of the decedent’s estate, there may not be enough money to pay the taxes due and cover the costs of the ongoing operation of the business.

Life insurance may be an option to provide money to pay any taxes due upon death or to maintain business operations. The person receiving the business is called a “beneficiary”. For tax purposes, a beneficiary that receives a business interest upon the death of a decedent, receives the interest with a basis equal to fair market value. That means the amount of capital gains tax due will be severely reduced if the business is sold shortly after receipt.

Necessary Documents
At the very least, a Will and possibly a trust should be in place to pass on the business interest. It may be prudent to also have a life insurance policy in place to provide money to pay taxes and continue the business.
Definitions & Basic Rules

**Estate Taxes:** There are two levels of government that may tax transfers of businesses to family members: 1) Washington State and 2) Federal government (IRS).

**Washington State:** Estate tax rates in Washington are progressive and range from 10% to 20%. The estate tax in Washington applies to estates with a net worth in excess of $2,193,000. Note that the estate tax is only applicable at a decedents’ death and does not apply to gifts made during life.

**Federal Government:** The federal government imposes an estate and gift tax at a rate of 40% on all transfers made via gift during life and at death. The federal government currently provides a federal gift and estate tax exemption in the amount of $11,580,000 per person, indexed for inflation. There is also an annual exclusion amount, currently $15,000, which allows a donor to gift up to $15,000 per year to any number of beneficiaries without having to use the federal gift and estate tax exemption amount or being subject to federal gift and estate tax.

**Will:** A will is a legal document by which a person expresses his or her wishes as to how his or her property is to be distributed at death. A will needs to be executed with certain formalities in order for it to be considered valid, and it is filed with a court upon a person’s death and will become public record.

**Pour Over Will:** A type of Will that provides that all assets are distributed to a Revocable (Living) Trust. This type of Will provides for privacy as all of the transfer and gift provisions are contained in the Revocable Trust, which is not filed with a court upon death.

**Revocable Living Trust:** A trust created during lifetime that can be revoked, amended, or modified during the grantor’s lifetime. Such a trust becomes irrevocable at death. The Revocable Trust contains all of the transfer and gift provisions of an individual’s estate plan.

**Power of Attorney for Financial and Health Care Decisions:** These are legal documents that are effective during a person’s lifetime and become ineffective upon a person’s death. A Power of Attorney allows you to designate individuals who can handle financial decisions on your behalf and make health care decisions for you. These documents can be effective upon incapacity or execution, and the scope of powers granted can be broad or limited.

**Assignments and Consent Resolutions:** With respect to any transfers made (whether during life or at death), certain formalities will need to be met in accordance with the terms of the governing documents. Oftentimes, governing documents will require a manager or existing member consent to a transfer or the admittance of a new member into the business; a consent resolution formalizes and documents this approval. An assignment is a document that transfers an interest; in the case of some entities, a stock certificate may also be required.