Klingman & Associates, LLC
An Independent Registered Investment Advisor

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Protecting and Managing Wealth Created from Your *Closely Held Business*

Critical considerations for business owners and their families as a business achieves financial success

A Select *Club*

Standing at the helm of a closely held company puts you in a very unique class of individuals. What you have achieved in building — perhaps after also founding the business — is something that not many people will fully appreciate. It is unlikely that you started, acquired, or took over your business solely because of the riches that might be possible. However, if you are fortunate enough to have led the company to great success, you may find yourself with opportunities to generate significant wealth for you and your family.

Some business owners build this wealth gradually, in a process that plays out over multiple decades: investing in the business with little to no wealth accumulation in its early years, accelerated growth as the business achieves success, and finally reaching peak earning years once the business "hits its stride." But in many cases, business owners realize significant wealth through a liquidity event (or a series of liquidity events). What appears as "overnight success" is the result of years — more often, decades — of dedication, hard work, and sacrifice. So how do you plan for, and manage through, the opportunities and complexities that come with this wealth?

Whether you build wealth gradually or through a single event, *it's essential to plan for, and manage through,* **the opportunities and complexities that come with this wealth.**

What's your *path?*

Many business owners have no intention of selling their business, and many never will. But for others, liquidity events in the form of recapitalizations, private sales, or initial public offerings present themselves.

Preparing for these possibilities today can have a lasting impact on your life and the lives of those around you. While the details involved in planning for these outcomes can be complex, most of them will fall from a single fundamental question depicted in Figure 1: How do you want your wealth to ultimately be divided — during and after your lifetime — among your family, your philanthropic legacy, and the government (through income, capital gains, and estate taxes)?

How much should you leave to your heirs? How do you ensure that your children, grandchildren, and even great-grandchildren will be prepared to manage this wealth and the responsibilities that come with it? What do you want your philanthropic legacy to be? Do you want to achieve the bulk of your giving during or after your lifetime?

These are all critical questions to consider — and answer.

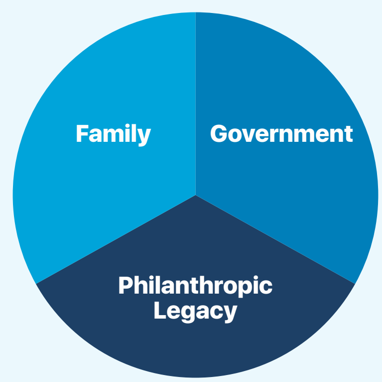
Each family is different in how they will answer them. As such, the specific strategies and tactics that are best for you will depend on your unique goals, your circumstances, and the opportunities that are presented to you.

This guide explores the Wealth Planning Cycle of Closely Held Businesses (the "WPC") and shares strategies, insights, and case studies from our work over almost 40 years as trusted advisors to the owners of closely held businesses.

Regardless of your specific path to liquidity, preparing for the possibilities *can have a lasting impact on your life and the lives of those around you.*

Figure 1

How do you want your wealth divided?



The *Wealth Planning Cycle* of Closely Held Businesses

Like many things in life, the lifecycle of business ownership from a wealth planning perspective can be broken down into key phases. In Figure 2 we visualize the three distinct stages of the WPC:

Figure 2

- **Pre-Liquidity:** from the point of founding, acquisition, or transition until a potential liquidity event is 6-12 months away
- **Liquidity Preparation:** the 6-12 months preceding a liquidity event
- **Post-Liquidity:** from immediately after a liquidity event until the time of your passing

We visualize this as a sequential, directional process, but it need not, and often does not, follow this linear progression. An owner that manages multiple liquidity events will experience part of this process on a loop, going through the process multiple times. Someone who intends to maintain ownership remains in the pre-liquidity phase. In certain situations, the transitions from one phase to another may take months, years, or decades whereas in other circumstances it can happen incredibly quickly. Understanding where you and your business are today is the first step in effective long-term planning.

Each of these stages presents unique challenges and opportunities across 7 distinct disciplines of wealth management. On the following pages, we will explore each stage of the lifecycle and share some of the mindsets, strategies, and considerations along the way.

7 Key Disciplines for Closely Held Business Owners

1. Financial Planning
2. Estate Planning
3. Tax planning
4. Philanthropic Planning
5. Investment Planning
6. Risk Management
7. Intrafamily Dynamic Management

Pre-Liquidity

In theory, the early days of your involvement with the company are when planning actions could have the biggest long-term impact from an estate, tax, and philanthropic perspective. In these years, the company's current value is commonly far below its potential future value. As such, you theoretically may have a unique opportunity to dramatically reduce future taxes that would be owed on this appreciation. However, for most business owners, reality does not follow the theory...and with good reason. Let's examine why.

In reality, few business owners are thinking about wealth planning during the early days of managing their business. Instead, their intense focus is on critical business building activities: finding and keeping customers; hiring, developing and retaining talented employees; and working to find the right industry partners. As the company achieves greater levels of success, the mental and physical demands on an owner's time and share of mind likely increase. But owners also have the demands of their lives outside of business. Whether it be spending time with their family (which often is growing in size during these earlier years), pursuing their personal interests and hobbies, or engaging with their community, it is not surprising that one's mindshare is distracted from wealth planning.

Just because you could do something, *doesn't mean you should do it.*

Also, at this stage, the possibility — and magnitude — of long-term wealth accumulation may be too abstract. Many a business owner in this stage has commented to the effect of, "If I am fortunate enough to have a significant liquidity event, I would end up with more money than I ever dreamed of. So will I really care if I end up paying more taxes?" Again, as individuals we often spend time on the things that actually matter to us at that moment, not on the things that theoretically should matter to us.

Beyond this, we commonly help business owners consider the old saying, "Just because you could do something, doesn't mean you should do it.”

We will discuss the notion of endowing your financial independence in the next section, but generally speaking, we advise people to become more aggressive with estate planning strategies after they are confident that they have secured their own future.

In the face of these understandable constraints, there are certain key planning considerations to address in these formative business years. Perhaps most significantly, business owners may overlook risk management issues as their companies grow. Owning a private company can build significant wealth; however, in this stage, it is common for the majority of that wealth to be tied up in the business itself. In such cases, the untimely death of the owner could produce a big stressor on their family, such as a big estate tax bill without the liquid cash to pay it. To protect against this, consider owning a life insurance policy sufficient to pay the potential tax liability. At the same time, making sure you have an umbrella policy attached to your homeowner's insurance can be increasingly important as your growing business may increase both the size and probability of potential personal liability exposure.

We advise people to become more agressive with estate planning strategies *after they are confident that they have secured their own future.*

As noted above, we frequently see owners that have foregone complex planning in this stage of the WPC. That said, many people do not effectively take advantage of their ability to make annual gifts to anyone they choose without gift or estate tax implications ($15,000 per year in 2021). For example, a married couple with three children can gift $90,000 per year to their children without using any of their lifetime gift credit. Whether funding premiums on insurance policies held in trust, transferring small pieces of ownership in their business, or saving for college through a 529 plan, consistent use of the annual exclusion can transfer significant wealth over time to your heirs, while putting the power of compounding to work for them.

Lastly, depending on the nature and structure of the business, designing and implementing an appropriate retirement savings vehicle for your business can enable significant wealth accumulation in these earlier years. Today, establishing a defined contribution plan has become quite common. Many business leaders consider it a necessary tool in attracting and retaining top talent to their organization. A majority of companies will default — and often rightly so — to creating traditional and/or Roth 401(k) plans for themselves and their employees. In certain situations, the simplified approach of establishing Simple IRA or SEP IRA plans may make more sense.

Although defined contribution plans are more common, when feasible, a defined benefit plan gives owners an opportunity to dramatically increase their retirement savings. Depending on the nature of the business, leveraging a defined benefit plan may allow an owner to save 4-5x (almost $300,000 per year) what they could save through a defined contribution plan. Regardless of the plan type, maximizing contributions for business owners — including when family members work in the organization — can offer a very attractive first-line of wealth accumulation.

Case Study

What's Our Number?

Situation: A couple had owned and operated a manufacturing business for more than 20 years. As they considered selling the business, they didn't fully comprehend how a transaction would impact their life moving forward.

Result: Through a series of discovery conversations, we helped them understand what "financial independence" truly meant for them and their family. As part of this, they discovered how much money they would require from a sale to "endow" their future spending needs. With this newfound grounding, they entered negotiations with prospective buyers feeling more confident about what a compelling transaction needed to look like — including the price, deal structure, and ongoing commitment to the business — to support their long-term personal goals. They ultimately sold the business, creating financial security for themselves and future generations of their family.

Liquidity *Preparation*

For most business owners, the 6-12 months approaching a liquidity event are extremely busy. Understandably, it's common to feel immense pressure during this period. As a result of this pressure, it's also common for wealth management considerations to take a back seat to the demands of running the business, preparing it for sale/IPO, and being present with your family. With time at a premium, we recommend owners focus on three core wealth planning objectives as they approach their initial liquidity event:

1. Endowing their future needs to ensure financial independence;
2. Leveraging vehicles to tax efficiently build generational wealth and support philanthropic goals; and,
3. Preparing for the impact of their newfound wealth on their loved ones.

You are the architect of your independence, so it's critical to take time and *really understand what this concept means to you.*

Endowing your financial independence

For many owners, a liquidity event offers a unique opportunity to achieve "financial independence" — to secure enough wealth (after-tax) such that all of your reasonable future funding needs can be supported by your existing portfolio. In essence, becoming independent from the need to work in order to support your family.

The first step is to define what exactly financial independence means to you and your family. For some families, independence means a second home in the mountains and college funds for each of their children and/or grandchildren. For others, it means a renewed focus on philanthropy. And for others still it means a freedom to lead their business to higher levels or invest themselves (and/or some of their wealth) in new ventures. You are the architect of your independence, so it's critical to take time and really understand what this concept means to you. In doing so, recognize that your vision of independence is likely different than that of your neighbors, your colleagues, and of others who have experienced liquidity events.

With this vision in mind, we can understand the potential spending needs throughout your lifetime. In turn, we can determine how much principle is needed — and how it should be invested — to support these spending goals.

Supporting your family and philanthropy through strategic gifting

Once you have endowed your own future, the focus often shifts to passing wealth to your loved ones and to supporting those causes you care deeply about. In this liquidity preparation phase of the WPC, some of the estate and philanthropic planning considerations that may have previously seemed too abstract should come into focus.

Once you have endowed your own future, the focus often shifts to *passing wealth to your loved ones and to supporting those causes you care deeply about.*

Significant appreciation in the value of your business often comes with a liquidity event on the horizon. There are many sophisticated strategies for passing value appreciation to your heirs outside of your taxable estate. From SLATs to GRATs to QPRTs, estate planning is filled with acronym soup. For the purposes of this discussion, we won't focus on the details of any one specific structure over another; rather, we will consider the essential strategic elements available to you.

A number of vehicles and techniques exist that allow you to transfer a specific asset, such as shares/units in your company or family home, outside of your taxable estate. With such transfers, the current value as well as all future appreciation of that asset are no longer subject to estate or gift taxes. However, the total amount that you can gift over your lifetime — based upon the value of the asset at the time of the gift — are limited by what's known as the Unified Credit, an amount that commonly changes over time with significant changes to the federal tax code.

Beyond these outright gifts of an asset, still other strategies allow you to gift most of the growth in the asset outside of your estate, while retaining the current value of the asset in your estate. The current value kept in your estate helps endow your financial independence while the appreciation passes to your loved ones outside of your taxable estate. Examples of this approach include sales of the asset to a trust that are financed by loans to the trust, Grantor Retained Annuity Trusts (GRATs), and writing fat-tail options on assets to a trust. When significant and often rapid appreciation is possible — situations such as approaching liquidity events — these tools can be incredibly effective at passing additional wealth to your heirs in a tax efficient way.

Some people we work with consider making significant charitable contributions, in or after their lifetimes, an important goal. Reduced taxation is certainly one outcome of this work, but the impact can run much deeper: done right, philanthropic planning can empower you to make a lasting impact on your community, cementing a legacy that will extend far beyond your lifetime. For such families, the 6-12 months prior to a liquidity event offer a critical time to enhance the potential impact of their charitable legacy.

Philanthropic planning can empower you to make a lasting impact on your community, cementing a legacy that will extend *far beyond your lifetime*

How? During this time, it is possible to fund many years of future expected donations, perhaps even for your entire lifetime, by gifting shares in the closely held business into a vehicle specifically designed for charitable giving. Setting up a family foundation, establishing a donor-advised fund (DAF), or creating a charitable remainder trust (CRTs) are all valuable options to consider. The scope of your giving, as well as the role that you want philanthropy to play in your family, will determine which strategies are most appropriate.

Not only can making such contributions support many years of future giving, but these donations also bring with them a number of key tax advantages. Like any charitable donation, you can deduct the contribution of your business ownership in the year it is made. This provides the opportunity to offset a considerable portion of the gains/income from the sale of your business. At the same time, depending on the vehicle you use for your giving, donating your ownership interest prior to transaction agreements being memorialized (including any letters of intent) can enable you to pay little to no capital gains tax on that portion of your ownership that you donate. The combined impact of these two elements on reducing your overall tax burden can substantially increase the amount you can give to charity and thus the long-lasting impact that your family can have on the broader community.

Will money change your family?

We often say that our clients care more about their families than they do about their money. When preparing for a liquidity event, it's natural to worry about the impact of the accompanying wealth on your loved ones. Your work ethic was a keystone of your business success — what if wealth negatively impacts the work ethic of your loved ones? The reality is this: the financial standing of your family doesn't determine work ethic or values. You do.

We often say that *our clients care more about their families* **than they do about their money...**

There are countless well-to-do families with exceptional value systems and work ethics. Likewise, there are many well-to-do families that allow wealth to negatively impact family dynamics, values, and motivations. Access to wealth is just one variable in a much larger and complex equation.

The financial standing of your family doesn't determine your children's work ethic or values. *You do.*

As you approach a liquidity event, we encourage you to begin considering your family's guiding principles and to begin to engage your family about your respective attitudes about money: what values, ambitions, and motivations do you hope to see in your children? What does a "financially responsible" family member look like to you? What scares you about what your wealth might lead to with your family?

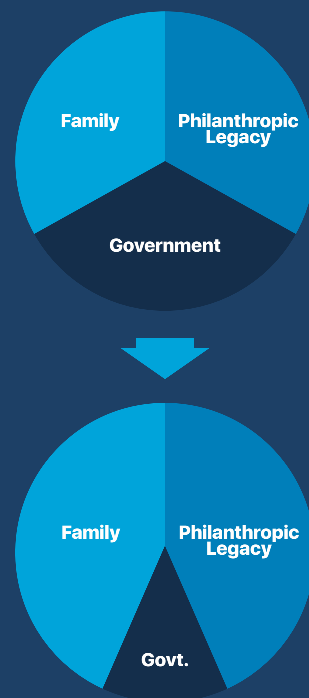
By considering these types of questions, and having these conversations before a transaction, your family can be more prepared for the new opportunities and responsibilities that can accompany generational wealth in the weeks, months, and years ahead.

Case Study

How can I minimize future estate taxes?

Situation: A couple invested in a consumer services business and became managing partners of the company. Over the course of a decade, as the business became more and more successful, a liquidity event (in this case, a series of liquidity events) seemed likely. The clients wanted to explore how to mitigate future taxes in passing wealth to their children.

Result: We first worked with the client to understand their long-term financial needs and goals. With this as the foundation, they established a series of "rolling" GRATs with lifespans matching their anticipated liquidity windows. Established as grantor trusts, the couple could pay taxes on behalf of the trust, further reducing their taxable estate. This structure enabled the family to remove more than $100 million from their taxable estate and to finance a $20 million charitable fund — while preserving more than sufficient wealth to ensure financial independence.



Planning significantly reduced this family's current and future tax burden.

Post-Liquidity

It may be counterintuitive, but the post-liquidity period can be the most challenging time for business owners. For many people, the sale of their business means the start of a new chapter in their life, a significant change of routine, and new financial realities and complexities to manage…plus more time to reflect on the past, present, and future. For this reason, we advise clients to avoid any significant lifestyle changes and/or financial decisions for at least 6-12 months (and typically longer) following a major transaction. It's important to allow yourself and your loved ones time to "live with" the psychological impact of your new wealth.

Think like an endowment

With significant liquidity in hand, we encourage families to begin thinking like an institution, much like the way many colleges and universities manage their endowments. The first part of this transition relies on the mantra, "Concentration builds wealth. Diversification preserves it." For years, so much of your financial net worth was tied up in your business. As a result, you willingly, and continually, invested in your business. Following a liquidity event, we work closely with clients to help them shift their mindset to preserving this capital to support their needs, and perhaps those of subsequent generations, with far less risk.

The day after the transaction closes, everything changes

— and nothing changes.

From an investment perspective, we recommend a shift in thinking for the core part of your portfolio. Before your liquidity event, your portfolio was likely heavily concentrated in your business holdings. Following an event, we help clients build broadly diversified portfolios using the principles of asset allocation. Over time, maintaining a diverse portfolio should allow you to not only support your current lifestyle but also continue to build your principal. At the same time, the risk profile of a more diverse portfolio is more consistent with the risk you "need" to take to achieve your goals.

Unlike a university endowment, you must also consider the income and estate tax implications of all your financial decisions. In this regard, while much of the planning opportunities and work are similar to those that existed before the transaction, business owners' appetite for more aggressive planning often increases after taking some proverbial "chips off the table" and endowing their own future. With this security in hand, significant planning opportunities may exist.

In many cases — such as a sale of your business to a private equity firm or an IPO — you will maintain sizeable ownership in an entity that is typically fairly illiquid after an initial transaction. When this occurs, we encourage families to aggressively leverage some of the tax and estate planning tools discussed earlier in this paper. By doing so, you can work to transfer much of the future appreciation in these assets outside of your estate in an effort to save significant amounts in future estate taxes.

Just as this period provides an opportunity to provide for future generations of loved ones, so too does it offer a chance to further expand your philanthropic legacy. In the post liquidity years of the WPC, you will have more experience living with your wealth, and your family will be older/more mature. With this evolution, it is common for the choices of giving vehicles to evolve as well. Through this process, it is critical to maintain an active dialogue with your wealth advisor about how your objectives and concerns may shift over time so that the strategies you use are best suited to you and your family.

Concentration builds wealth. *Diversification preserves it.*

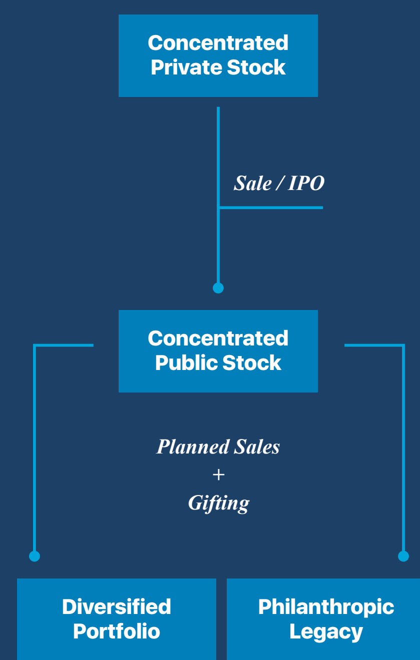
Case Study

What do I do with this company stock?

Situation: After selling his company, the founder of a technology firm held a significant amount of shares in a now public company. As he stayed with the firm post transaction, he was accumulating additional incentive stock options through an ongoing employment agreement.

Result: We first worked to de-risk the founder's portfolio and endow his family's future lifestyle. Through a series of planned sales, we reduced his stock concentration and established a diversified asset allocation strategy that could easily support his family's cash flow needs. At the same time, the client funded a series of family trusts to mitigate future estate taxes.

Additionally, we worked with the family to establish a multi-million-dollar charitable giving structure incorporating a family foundation and a Charitable Remainder Trust. Through this collaboration, we enabled the family to comfortably embrace their post liquidity financial life and to establish a structure to help bring their children into their tradition of giving.



Need a *trusted advisor* for your journey?

Business ownership is a journey that can follow a number of paths, each presenting unique opportunities and challenges in building and preserving wealth. We hope this guide provides several considerations for you and your family.

We've walked this path together with families many times before. Helping families navigate The Wealth Planning Cycle of Closely Held Businesses from a financial, emotional, and tactical perspective is core to what we do as a firm.

If a partner for your journey would benefit you and your family, we invite you to connect with our team.

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