BUSINESS SUCCESSION FOR CLOSELY-HELD BUSINESSES

We’re always better as a team.

- This presentation should demonstrate the benefits of different perspectives.
- Please participate!

The biggest challenge you face as an advisor in discussing business succession is addressing the emotional issues in connection with succession.

- Business owners don't want to talk about feelings, they want to get things done. And yet the feelings are what drive them.
- The business is a family member. Business owner/parents often treat the business as they would a child, nurturing and developing it.
  - This can create challenging feelings on the part of the "biological" children.
- The business is the owner's identity. The owner has spent so much time working on it, worrying about it, that it becomes who she is.
  - In other words, she doesn't want to retire and play golf, because by doing so, she's giving up her identity.
  - The owner's perspective is often very different from ours as advisors. We often can't wait to retire.

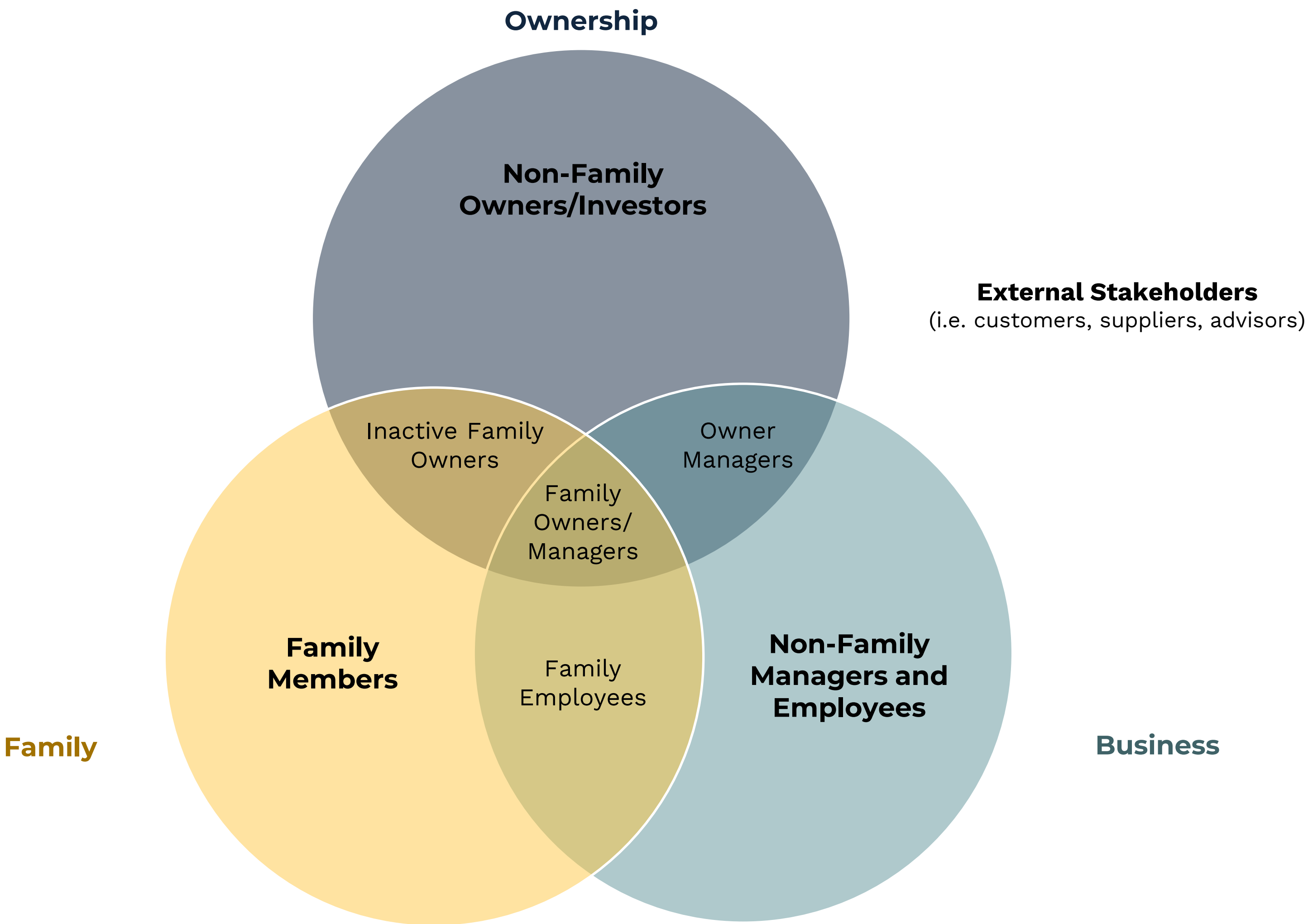
EMOTIONAL ROADBLOCKS (CONT.)

- Business owners may have regrets. Perhaps how much time they've spent with the business, rather than people, how much their personal relationships are tied up with work, etc.
- Business owners won't tell you everything.
  - The owners themselves may not have fully sorted out their feelings.
- Because they are more comfortable dealing with business strategies and tactics than feelings, the business owner may ask you about certain techniques (ESOPs, etc.). It may seem like an objective conversation, yet it may not seem to move forward. This may be because the owner is consciously or unconsciously trying to deal with emotional issues, rather than strategic ones.

In light of these emotional issues, succession conversations can be challenging.

- Business owners won't usually tell you about the real concerns at first.
  - By nature, a business owner isn't inclined to take these emotional issues into account, and may actually be offended if you introduce them too soon.
  - It may take several discussions before you uncover the core issues.
  - You may have to begin talking about the objective questions they've raised before you can get to the core concerns.
- For the closely-held business, succession planning and estate planning are inseparable. To get to the best solution, you often have to have a broader mindset.
- Clients always talk about saving taxes. But taxes are almost never their biggest concern (otherwise they'd take our advice much more frequently).

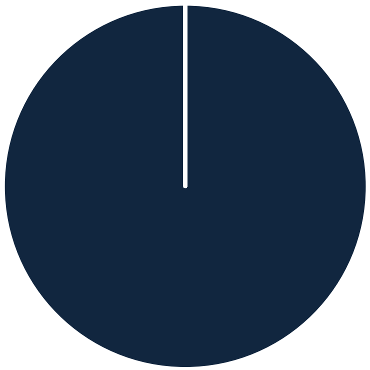
MANY DIFFERENT RELATIONSHIPS



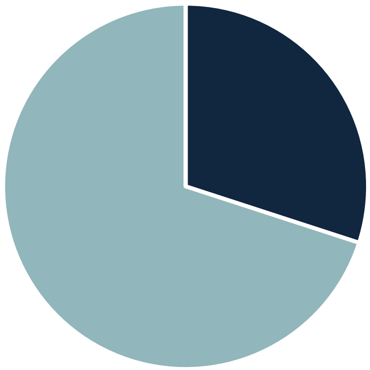
ODDS ARE AGAINST IT

Percentage of family firms surviving future generation...

1st Generation - 100%

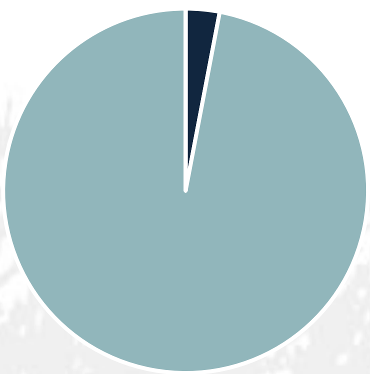


2nd Generation - 30%



3rd Generation - 12%

4th Generation - 3%



Regardless of generation in question a family owned company has roughly a 1 in 3 chance of ownership succession.

Source: Joseph Astrachan, Ph.D., Editor, Family Business Review 1999

Estate Planning Basics:

- Four Ways to Pass Property at Death:
    - Through probate;
    - Through right of survivorship;
    - Through beneficiary designation; and
    - Through trust
- Titling – Dictates how property will pass
- Control vs. Equity

Trust Design.

- Trustee – Party that holds title to the business
- Trust Advisor or Protector – Optional party with only limited duties (voting the stock, running the business, etc.)
- Distribution Provisions – Does the business generate enough income to satisfy the terms of the trust?
- Trust income taxation – Who gets taxed?

Buy-Sell Agreements.

- Corporate Redemption – The company is contractually obliged to buy the deceased owner's interest.
- Cross-Purchase – The other owners do the purchasing (complicated if more than 3 owners).
- Not a way to pass property; rather, it's a set of rights and responsibilities of the new owner.

Estate Tax Basics.

- Federal – Exemption of $12.06 million for each taxpayer; rate is a flat 40%
- Washington – Exemption is $2.193 million; rate goes from 15 – 20%
- Oregon – Exemption is $1 million; rate goes from 10 – 16%
- Generation-Skipping Transfer Tax – Federal tax applied to certain transfers; numbers same as for Federal estate tax

Estate and Gift Tax Valuations.

- Estate and gift taxes are based on the value of assets in the decedent's estate or of gifts made. So if you can reduce the value, you can reduce the amount of the tax.
- Entity Discounts – The value of a decedent's interest in a business can be lower than the pro rata share of the underlying business (lack of control and lack of marketability discounts).
- Using discounts can be useful because they can significantly reduce tax liability, but they can also create disparities among beneficiaries if one beneficiary gets business interests and another gets an "equal" amount of cash.

Some important Estate Tax Issues.

- The federal exemption of $12.06 million is set to go down to about $6 million in 2026. From a pure tax planning perspective, it’s better to give significant gifts before then.
  - Challenge – In order for this technique to work, the donor must give away all of her exemption amount ($12 million). Very few clients are warm to this idea.
- In the case of married couples, planning for state estate tax planning involves creating trusts, which can create capital gains tax problems.

THREE CHOICES FOR BUSINESS

DIE IN THE SADDLE	SELL IT	GIVE IT AWAY

- Can also be some combination of the three.
- All options are valid if proper planning is done.
- Using this format is a helpful way to start the conversation with your client.

Foundational Questions.

- Who should run the business when you can't, and how is that documented? What if you become incapacitated?
- If the successor has been determined, has it been announced, and did it or will create disappointment or hard feelings in others?
- Is there adequate liquidity to pay taxes on the business interest and to make distributions to other beneficiaries?
  - Although estate taxes are typically due within 9 months of the date of a decedent's death, there are provisions allowing for the deferral of that payment, sometimes with favorable terms.

Unequal Treatment of Beneficiaries.

- Very often, owners will want to give the business to only one beneficiary (usually the one who has been involved in the business for a long time).
- How do you treat the other beneficiaries?
  - Valuation can be a problem, esp. when trying to use valuation discounts (can't use inconsistent valuations).
  - One consistent argument for unequal treatment is that the beneficiary getting the business has actually added value to it.
  - No single good answer.
- Communicate! If beneficiaries are going to be treated unequally, they shouldn't find out only after the owner has died.

Using Trusts.

- Trusts can be designed to give equal cash flow to all beneficiaries, while isolating management to a few key people.
- Roles – Trustee, trust protectors, advisory committees.
- Must be very carefully and thoughtfully drafted.
  - Can trustees borrow? Must be allowed in document.
  - How are distributions decided?
  - Who determines compensation if one of the beneficiaries but not all is a key employee?

Foundational Questions.

- To whom do you plan to sell: family, employees or third parties? Sales terms may change, depending upon the answer.
- What will you live on after the business is sold? Are you depending on the sale proceeds for your support, and are those proceeds in the form of a lump sum or payment from an indebtedness?
- Life After Sale – If the sale is to family, are you willing to stay out of the business? Do you have a hobby lined up?

Sales to Families.

- Often start with determining value – Goals can include making the purchase affordable while still providing enough revenue for retirement.
- Do all family members get a chance to buy in? If not, does allowing one child to buy the business at a discount give that child an unfair estate planning advantage?
- Who's in charge following the sale? Pre-sale activities should include ensuring a solid management team is in place after owner's departure.
- Owners must REALLY step back.

Sales to Employees – ESOPs.

- How – Companies set up a trust fund for employees and contribute either cash to buy company stock, contribute shares directly to the plan, or have the plan borrow money to buy shares. If the plan borrows money, the company makes contributions to the plan to enable it to repay the loan. Contributions to the plan are tax-deductible. Employees pay no tax on the contributions until they receive the stock when they leave or retire. They then either sell it on the market or back to the company. Provided that an ESOP owns 30% or more of company stock and the company is a C corporation, owners of a private firm selling to an ESOP can defer taxation on their gains by reinvesting in securities of other companies.
- Why – About two-thirds of ESOPs are used to provide a market for the shares of a departing owner of a profitable, closely held company. Most of the remainder are used either as a supplemental employee benefit plan or as a means to borrow money in a tax-favored manner.
- Why Not – Fruitful vehicles for creating litigation.

Sales to Third Parties.

Some things buyers pay more for:

- Sales and profits growth;
- Location;
- Good brand/marketing;
- Solid, long-term staff;
- Good policies, procedures, financials, controls;
- Good future – No litigation threats, solid placement for the future, etc.

What are You Selling?

- Selling or keeping real estate?
- Remove excess cash
- Good will and intangibles.

Foundational Questions.

- Typically only two groups are given business interests: family and charity.
- If charity, is there a plan in place for a sale shortly afterward?
- Often, gifts are made in conjunction with other techniques (e.g., sale of the bulk of the business to a third party, but with a gift to charity of a smaller portion before the sale).
- Charitable gifts often involve income tax savings devices, like charitable lead trusts and charitable remainder trusts. These are highly technical and require sophisticated representation.
- Warning – Assignment of Income doctrine

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MANY DIFFERENT TOOLS

SALE OR TRANSFER TIMING

Timing	During Life of Owner			At Death of Owner		
Alternatives	Gift to Children/ Descendents	Sell to Employees of Company	Sell to Third Party	Transfer to Children/ Descendents	Sell to Employees of Company	Sell to Third Party
Issues	Gift Tax Valuation of Business	Capital Gains Tax	Capital Gains Tax	Estate Tax	Pricing and Funds for Employees to Use for Purchase	Identifying the Purchaser, Pricing and Funds for Third Party to Use for Purchase
Solutions	Family Limited Partnerships/ GRAT/IDGT	Employee Stock Ownership Program	Charitable Remainder Trust/Tax Free Exchange/ Installment Sale	Bequest	Buy/Sell Agreement with Defined Price (formula) and Life Insurance Proceeds to Fund Purchase	Identify Third Party w/ Buy/Sell Agreement w/ Defined Price (formula) and Life Insurance Proceeds to Fund Purchase
Benefits	Discounts Value for Transfer Tax	Defers Capital Gains Tax	Either Eliminates or Defers Capital Gains Tax	Step-Up in Basis	Provide Liquidity for Take Out to Pay Estate Taxes – Maintain Lifetime Control	Pre-Identified Buyer Provides for Quick Sale to Meet Estate Tax Liquidity Needs

SOME ADVANCED TECHNIQUES

- Take yourself out of a controlling position during life:
  - Create nonvoting and voting shares (or manager interests for LLCs);
  - Give away enough voting interest so that no one person has more than 49% (consider 1/3 to husband, 1/3 to wife, 1/3 to others).
  - At death, even if the owner owns 90% of the equity, she doesn’t have control, so discounts should apply.
- Sale to a grantor trust:
  - Owner creates a trust, funds it with at least 10% of the value of the owner’s interest in the company.
  - Owner recapitalizes company so that she doesn’t have control.
  - Owner sells the business to the trust in exchange for a note.
  - Sale price is determined using valuation discounts, so purchase price is reduced significantly.
  - Because it’s a grantor trust, no capital gains on sale.
  - Beneficiaries or key personnel can be trustees.
  - If done correctly, no gift tax from the sale, only the note is in the owner’s estate, trust can control operations.
- CRTs
- GRATs

USING LIFE INSURANCE

- Life insurance provides liquidity for:
  - Funding buy-sell agreements;
  - Making equalizing gifts to other beneficiaries;
  - Supporting the surviving spouse as the company goes through succession.
  - Paying estate taxes on the business so it doesn't have to be sold. Very common, although there are other alternatives.
- Choosing the right type
  - Term vs. cash value products.
  - Don't buy insurance like appliances. Make sure conservative illustrations are used.
  - ILITs (irrevocable life insurance trusts) – Can be helpful, but are complex and often resented shortly after they're created.

- Lawyers and CPAs have privilege as to their communications with clients.
  - Very important is complex estate tax planning is involved, because the IRS can’t use those communications to prove tax evasion.
  - Financial professionals don’t have such privilege (even those of us who are still licensed professionals), unless we’ve been specifically hired by the attorney or CPA.
- Financial Professionals: Be careful with communications.
  - Don’t put anything in writing that you wouldn’t want to have produced in Tax Court.
  - Excuse yourself from sensitive phone calls with attorneys or CPAs.