

Business Succession Strategies



**ATLANTIC MANAGEMENT COMPANY
INCORPORATED**

ATLANTIC MANAGEMENT COMPANY

Atlantic Management Company is a leading valuation and financial advisory firm that has been serving New England's business, legal and financial communities since 1968. We provide our clients with a broad range of specialized services that meet their valuation, merger and acquisition, ownership transition, and corporate finance needs.

Our client list is widely diversified and includes many of New England's largest and most successful companies in both the private and public sectors. We work with companies in virtually every industry from basic manufacturing to emerging high-tech disciplines, as well as retail, wholesale, and consumer and business services.

Atlantic's reputation for excellence reflects the technical capabilities of our professional staff. Individually, each is a results oriented specialist with outstanding academic and career credentials. Together, they comprise a team with backgrounds in the fields of finance, economics, banking, accounting, taxation, engineering and management. We invest in people to further develop our firm and insure that our clients' needs are met in a timely manner. And we continually broaden our research capacity and computer modeling capabilities to provide our professional staff with state of the art analytical tools and data resources.

In every engagement we undertake, one quality prevails: Judgment. The result of over 30 years experience, the judgment we bring to each assignment uniquely qualifies us to develop workable solutions to complex business and financial issues.

Introduction

Business owners assume their businesses will survive them, but they are reluctant to deal with the planning required to insure that continuity. This reluctance is understandable since the issue of succession is an acknowledgment of one's mortality. Nevertheless, failure to do some planning almost certainly guarantees the Internal Revenue Service will be a major beneficiary of the business owner's estate.

To avoid cutting the IRS in for more than their fair share, two issues must be addressed: Who should succeed the present owner and How can it be accomplished. This monograph focuses on the How and discusses eight strategies, ranging from bequeathing the stock in a will to setting up an Employee Stock Ownership Plan. The particular device used depends on who the successor is, and - more importantly - how much of the business value the owner wants to preserve for their family.

Bequest

As is often the case with family businesses, succession is implemented by the terms of a will. Admittedly, this is probably the easiest strategy to use, but it has its drawbacks.

For illustration purposes, assume the taxable estate consists solely of the business. Depending on the value of the business, the effective tax rate will be anywhere from 39 percent to 48 percent, which is a rather high price to pay for not doing more creative succession planning.

	Company A	Company B
Taxable Estate	\$2,000,000	\$10,000,000
Estate Tax Rate	39%	48%
Net Proceeds to IRS	\$780,000	\$4,800,000
Net Proceeds To Heirs	\$1,220,000	\$5,200,000

Gifting

As an alternative to bequeathing the business to the intended successor, a gifting program can be structured to convey ownership gradually over a period of years. Whether or not a gradual gifting program makes sense depends on three factors: (1) the age and life expectancy of the owner; (2) the value of the business at the time the gifting begins; and (3) the potential appreciation in value. If a gradual gifting program is not appropriate, a one time gift can be made which freezes the value of the

business, and transfers future appreciation to the donee.

In either case, the value of the gift must be based on the fair market value of the business. As defined by the IRS and the courts, fair market value is "*the price at which a property would change hands between a willing seller and a willing buyer, with neither being under any compulsion to sell or to buy, and with both parties having reasonable knowledge of the relevant facts*". Based on that definition, using the corporation's book value instead of its fair market value is not only incorrect, but it can also have costly repercussions.

A case in point is a business owner who made a one-time gift of all of his stock to his son, based on the book value of the shares which was \$300,000. A few years later, the business owner died and his estate tax return was subsequently audited, including an examination of his lifetime gifts. The IRS asserted a tax deficiency of \$350,000, claiming the fair market value of the stock at the time of the gift was \$1.3 million rather than the \$300,000 claimed. The IRS prevailed and the total deficiency, including penalties and interest, totaled over \$700,000!

The table below reflects the highest gift and estate tax rates through 2010 as determined by the 2001 Tax Reform Act, as well as the exclusion amounts for gift and estate taxes. It should be noted that the impact of this Act is repealed effective January 1, 2011, and the highest gift and estate tax rates will be 55 percent!

Tax Year	Highest Gift Tax Rate	Gift Tax Exclusion Amount	Highest Estate Tax Rate	Estate Tax Exclusion Amount
2002	50%	\$1 M	50%	\$1.0 M
2003	49%	\$1 M	49%	\$1.0 M
2004	48%	\$1 M	48%	\$1.5 M
2005	47%	\$1 M	47%	\$1.5 M
2006	46%	\$1 M	46%	\$2.0 M
2007	45%	\$1 M	45%	\$2.0 M
2008	45%	\$1 M	45%	\$2.0 M
2009	45%	\$1 M	45%	\$3.5 M
2010	35%	\$1 M	0%	N/A
2011	55%	\$1 M	55% + 5% surtax	\$1.0 M (Adjusted for inflation)

Stock Redemption

In this context, a stock redemption is actually a combination of a stock sale and redemption in which part of the owner's stock is conveyed to their successor, and the remaining shares are redeemed by the corporation. Since the redeemed shares are held by the corporation as Treasury Stock, the only shares outstanding are those owned by the successor. A variation of this transaction, which is appropriate in some family businesses, combines a gift with the redemption.

Since the redemption side of the transaction is between the selling shareholder and the corporation, payment for the redeemed shares comes from the corporation which makes the transaction more affordable for the successor.

There is one drawback to using a redemption in a family business. Under current tax law, a redemption between related entities qualifies for long term capital gain treatment only if the seller's relationship with the company, after the transaction, is limited to that of a creditor. In other words, if the selling shareholder benefits from favorable tax treatment on the sale proceeds, they must sever their relationship with the business, other than as a creditor.

Stock Recapitalization

One of the most effective business succession strategies is a stock recapitalization which can be used to transfer family businesses. Chapter 14 of the 1990 Revenue Reconciliation Act is the rule book for recapitalizations, which offer a number of unique advantages to family businesses.

To illustrate a typical transaction, take the case of a sole shareholder whose stock has an appraised value of \$2 million. He has a daughter in the business and a son who is not in the business. His objective is to transfer the business to his daughter but he also wants his son to share in the wealth the business represents. As a starting point, the corporation is recapitalized into a combination of preferred stock and new common stock. Since the rules require that at least 10 percent of the corporation's equity value be allocated to the new common stock, we'll assume the recapitalization resulted in \$1,800,000 of preferred stock and \$200,000 of new common stock. The shareholder then exchanges his existing common stock for the newly issued preferred stock and common stock. He retains the preferred stock and gifts the common stock to his daughter.

A review of the Chapter 14 regulations makes it crystal clear that the valuation of the preferred stock must have some basis in reality. Merely assigning a variety of discretionary rights (bells and whistles) to inflate the value is not acceptable. In fact, liquidation, put, call and conversion rights are valued at zero unless the rights are to be exercised at a specific time and for a specific amount. Under the rules, the preferred stock must:

- Have voting rights
- Pay market rate dividends
- Have cumulative dividends

This brings up the affordability of the dividends. The example assumed the father retained \$1,800,000. As part of the valuation process, it was determined that a 10 percent yield was required to justify the assigned value, which translates into annual dividends of \$180,000. From a cash flow standpoint, the dividend payout shouldn't create a drain since the funds that had been used to pay the father's salary can be redirected to pay his dividends.

This line of reasoning only works up to a certain point. For companies worth over \$3 million, for example, the dividend payout could create a cash drain on the company. In those cases, a combination of gifting (using the unified credit exemption), recapitalization, and "second-to-die" life insurance coverage can be used.

Stepping back from the mechanics of the transaction, let's take a look at what the recapitalization has accomplished. First, the new common stock, along with its potential appreciation, has been conveyed to the owner's daughter. Second, for estate planning purposes, the value of the father's interest in the business has been frozen. Third, dividend income from the preferred stock creates an income stream for the father. And fourth, some or all of the preferred stock can be given or bequeathed to the son who is not in the business.

When you consider the available options for transferring a family business, a properly structured recapitalization offers unique financial and tax benefits to both generations.

Buy Sell Agreements

Chapter 14 of the tax code also contains rules for buy-sell agreements in family businesses. For years, family businesses have been using buy-sell agreements to transfer ownership from one generation to another. These agreements were designed to be exercised at the death of the business

owner and provided for the owner's children to purchase their stock at either a fixed price or a price based on a pre-determined formula. More often than not, the buyout price was less than the stock's fair market value.

Under Section 2703 of the Internal Revenue Code, which deals with buy-sell agreements entered into or modified after October 8, 1990, the terms of a buy-sell agreement will be disregarded in determining the fair market value of the transferred stock unless:

1. The agreement is a bona-fide business arrangement.
2. The agreement is not a device to transfer property to family members for less than full and adequate consideration.
3. The terms of the agreement are comparable to similar arrangements entered into by person's in arm's length transactions.

Following the logic of these regulations, a buy-sell agreement based upon a formula will not establish estate tax value for closely held stock unless the formula value approximates the appraised fair market value of the stock. With that in mind, structuring the terms of a buy-sell agreement using 1 times book value, or 5 times earnings, will not be acceptable to the IRS unless the value derived from that type of formula can be proven, by an independent appraisal, to be fair market value.

When you consider the percentage of estate tax returns that are audited by the Internal Revenue Service, it's advisable to base the buyout price on the appraised fair market value of the stock at the time the buy-sell agreement is prepared. The agreement can provide for periodic updates to the valuation to insure that the buyout price remains valid.

Family Limited Partnerships and Limited Liability Companies

Family Limited Partnerships (FLPs) and Limited Liability Companies (LLCs) continue to grow in popularity as an estate-planning tool, and with good reason. They are an effective way to transfer wealth from older to younger generations, assist in reducing estate and gift taxes, and provide substantial protection from the claims of creditors. What's more, a family business owner or an individual with substantial assets can also maintain control and flexibility over business affairs, which is a benefit that other estate planning tools do not provide.

The creation and structure of an FLP is based upon a partnership agreement. Typically, FLPs are formed such that the general partner holds a 1 percent interest, and limited partner(s) collectively maintain a 99 percent interest. However it should be noted that the ownership percentages are by no means consistent, and will vary depending upon the estate planning requirements of the parties involved.

The creation and structure of an LLC is nearly identical to that of an FLP, with one notable difference being terminology. In LLCs, the individual maintaining control is referred to as a manager, whereas all other individuals are referred to as members.

The first step in structuring an FLP or LLC is a transfer of assets into the partnership or company in exchange for an interest in the entity. The most commonly contributed assets include: cash, real estate, marketable securities, and stock of a closely held business.

Once the transfer of assets is completed, and the general and limited partners or managers and members are determined (usually the parents are general partners/managers as well as limited partners/members at the outset), the process of transferring wealth can begin. This process allows the parents to maintain control of the entity, without having full ownership of its assets. As the gifting process continues, the parents transfer a portion of their limited partnership or member interest to their children or other limited partners/members, until such time as their limited partnership or member interest has been exhausted.

The general partner/manager controls the assets, operations and distributions of the FLP/LLC, while the limited partners/members have very restricted rights. As such, the value of a limited partnership/member interest in an FLP/LLC can be substantially less than the fair market value of the same percentage interest in the underlying assets of the FLP/LLC. This reduction in value is quantified through the use of valuation discounts, specifically minority and lack of marketability.

To illustrate the impact a properly formed FLP or LLC can have on estate and gift taxes, consider the following example. It should be noted the example refers to an FLP, however it's equally applicable for an LLC.

- Two parents form a family limited partnership and contribute \$2.0 million in marketable securities and real estate. At the outset, they hold a 1 percent general partnership interest, and a 99 percent limited partnership interest (\$1,980,000).
- Based on an independent valuation analysis, the combined minority and marketability discounts were determined to be 45 percent, which, when applied to the 99 percent interest, resulted in a discount of \$891,000.
- Once the value of the parent's 99 percent limited partnership interest has been determined, they can then gift it to their children. Assuming the unified credit exemption was available for both parents (currently \$1,000,000 per parent), there would be no gift tax due. Nor would there be any estate tax due at the time of the father's death, assuming the value of the 1 percent general partnership interest will be less than the remaining unified credit.
- If an FLP had not been established, and there was no estate planning accomplished, the estate taxes due at the time of the surviving parents death would have been \$346,000, which assumes that the unified credit exemption was used for only one of the parents.

table, and you will be required to provide seller financing.

Strategic buyers such as suppliers, customers, competitors, or consolidators, are typically looking for a synergistic fit between their company and yours. Strategic buyers will more than likely look to consolidate some administrative and management functions, and that often means that current top management is expendable. They are not as sensitive to the size of your company, or in some cases your earnings, since they are looking for the synergy that results after the sale is completed.

Financial buyers include those companies that are managing "funds", and are looking to invest in a number of different companies. Typically they are interested in investing in companies that have the ability of growing substantially during the five-year period immediately following the transaction. These investors are looking to either take the company public or have it acquired by a much larger company, and are looking for management to stay in place. The benefit to the seller in these transactions is that it is a way of gradually exiting the ownership of your company while at the same time remaining active in its operation.

Employee Stock Ownership Plan

One of the most tax advantaged business succession strategies is an Employee Stock Ownership Plan (ESOP). With an ESOP in place, shareholders have a ready market for their closely held stock. They can sell that stock to the ESOP and defer the federal income taxes on the sale which, in effect, makes the sale tax-free as far as the IRS is concerned.

The ability to elect what is essentially a tax-free sale has been reason enough for many corporations to go the ESOP route. Not only does it mean a substantial tax savings for shareholders, but it opens the door to a broad range of financial planning options.

Take the case of a shareholder who is planning to retire and wants to sell his company. In a conventional transaction he would have to find a buyer, negotiate the sale, and then pay capital gains tax at roughly 20 percent. Assuming a \$4 million gain on the sale, the federal tax would be \$800,000. If he sets up an ESOP however, the buyer is already in place and there's no capital gains tax on the sale. The following table compares the tax advantage of structuring a sale to an ESOP rather than a conventional stock sale.

	With FLP	Without FLP
Taxable Amount	\$1,980,000	\$2,000,000
Less: Combined Discounts	<u>\$891,000</u>	<u>\$0</u>
Preliminary Taxable Amount	\$1,089,000	\$2,000,000
Less: Unified Credit	<u>\$1,089,000</u>	<u>\$1,000,000</u>
Indicated Taxable Amount	\$0	\$1,000,000
Estate Tax Percentage	<u>0.0%</u>	<u>34.6%</u>
Estate Tax Due	\$0	\$346,000

Sale to a Third Party

Depending upon the facts and circumstances, an outright sale of the company to a third party may be the best option. Potential buyers include: key managers in the company, strategic buyers, and financial buyers.

Key managers are more than likely the individuals who have helped make the company the success it is today, and will continue the core policies that you have built over the years. The benefit of selling your company to your current managers is that you have worked with them and their abilities are well known to you. The downside is that in all likelihood, an acquisition by this group will bring little cash to the

Electing the tax-free rollover generates an additional financial benefit that should not be overlooked. In addition to saving \$800,000 in federal taxes, the shareholder benefits from the earning power of those funds. Assuming a 5 percent after-tax return for 15 years produces an additional financial benefit of approximately \$860,000. So on a gain of \$4 million, the shareholder derives a total additional financial benefit of over \$1.6 million.

	Stock Sale	ESOP
Gain On The Sale	\$4,000,000	\$4,000,000
Federal Income Taxes	<u>\$800,000</u>	<u>\$0</u>
Proceeds	\$3,200,000	\$4,000,000

When a succession plan involves a family business, an ESOP allows the retiring stockholder to provide for all family members in a way that's most beneficial to them, and to future business operations. In many cases, the value of a closely held business represents the bulk of the retiring shareholder's net worth. Without an ESOP, the shareholder would probably divide his stock equally among his children, whether they are active in the business or not. While this arrangement may seem to be the most equitable way to provide for the next generation, the results can be disastrous - for both the family and the business.

An ESOP provides an alternative, and one that's fairer to all parties in the long run. The first step is to get some of the corporate stock into the hands of younger family members who are active in the business. This can be arranged through a gifting program or a taxable sale. When Dad is ready to retire, he sells his remaining stock to the ESOP, elects the tax-free sale, and invests the sale proceeds in qualified replacement securities such as a diversified stock portfolio.

The ESOP transaction accomplishes three things: (1) it maximizes the return to the stockholder; (2) it converts non-liquid closely held stock into a liquid stock portfolio which can be used to provide for family members who are not active in the business; and (3) it sets the stage for the next generation who will take over the business.

An ESOP is equally effective when the successor is an unrelated employee and the transaction is structured as a management buyout. Such was the case in a recent transaction involving a company with sales of \$5 million. Knowing the owner had been talking about retirement, two upper level managers approached him about buying the company using an ESOP. The existing corporation was recapitalized

with common stock and convertible subordinated debentures. The ESOP acquired 100% of the common stock and borrowed the full purchase price at the banks' lending rate. The managers acquired the convertible subordinated debentures which paid 10% interest a year. Once the ESOP loan is paid off, and assuming certain performance criteria are met, the managers will be able to convert their debentures into a substantial amount of common stock. In addition, as participants in the ESOP, they also have an interest in the common stock owned by the ESOP.

Even with the financial benefits and tax advantages ESOPs provide, they are not appropriate for every company. Ideally, a company that is considering an ESOP should be profitable with a healthy cash flow. Also, since annual funding is based on a percentage of payroll, the company's payroll should be of sufficient size to permit appropriate annual contributions.

Valuation

The logical first step in any business succession plan, particularly in family businesses, is an independent valuation of the company. Or in the case of a family limited partnership or limited liability company, a valuation of the partnership or member interest being conveyed. The valuation is a complex task that requires a combination of technical skills and informed judgment.

Once the valuation is completed, the succession plan can be implemented using the transaction that's most appropriate given the facts and circumstances, and one that will provide the greatest financial benefits and tax advantages to all the parties involved.

Failure to have a realistic defensible value determined by a qualified independent appraiser can have far reaching and often costly consequences. And in fact, there are substantial penalties that may be imposed by the IRS if the succession plan is based on a flawed valuation or no valuation at all!

In view of the potential benefits of a carefully structured business succession plan, the importance of the valuation function must not be underestimated. When you consider that the implementation of the succession plan hinges on the validity of the valuation, the need for an accurate and objective appraisal becomes obvious. Taking that one step further, the calculation should be prepared by a qualified, independent appraiser who has experience testifying as an expert witness in court or before the Internal Revenue Service. Should the transaction be

challenged by the IRS, the appraiser will be able to support the written report with clear and convincing testimony in defense of the value on which the transaction was based.

In Conclusion

The current estate and income tax laws present a problem for virtually every succession plan that includes a closely held company. But these same laws also provide ample opportunity to minimize the tax burden through creative succession planning techniques.

However, when it comes to succession planning, too many business owners adopt an ostrich attitude toward the subject, and keep their heads in the sand. Instead of assembling a professional succession

planning team to design a program for their future financial security, they choose to ignore the issues. They assume that by ignoring it, the problem will disappear.

Unfortunately, the only thing that will disappear is the value of the company they've worked so hard to build, which is also probably their single most valuable asset.

Whether or not a succession plan is implemented depends on you. You're the one who has to make the first move to see that the business continues. When you consider that your future and the future of your company is at stake, doesn't it make sense to start planning today? Otherwise, instead of your family enjoying the personal wealth the business represents, the IRS will reap the benefits.