

Succession and Exit Planning for the Privately-Held Business



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Exit planning is the overall process which explores all strategic options available to a business owner which includes succession planning and sales strategies.

A well designed exit plan enables business owners to:

- Control the process and timing of their business exit
- Achieve their personal financial goals
- Maximize their company's value
- Facilitate their retirement
- Explore all available options for their exit
- Promote long-term growth and survival of their business
- Minimize taxes on the transfer or sale of their business.

Succession and Exit Planning for the Privately-Held Business

Failure to have an exit plan typically results in:

- Not achieving their highest value for their business
- Not being in control of timing or strategy of the exit plan
- Creating family fairness issues
- Paying additional income and estate taxes
- Not providing an atmosphere for longevity of key employees concerned about the control of the business in the future
- Creating uncertainty for all stakeholders.

Succession and Exit Planning for the Privately-Held Business

- Succession and exit planning is a **highly personal process**. There is no canned “one size fits all” plan.
- Every plan must consider the **very unique individual** circumstances of its situation.
- A successful exit and succession plan should be one that can be **easily updated** to the current state of affairs.
- Succession planning is an **orderly process** by which the ownership and management of a business are transferred to the next generation in a tax-effective manner.

Succession and Exit Planning for the Privately-Held Business

Reasons not to begin the exit planning process now:

- I will live forever always being of sound mind and body.
- No one other than me could ever run this business.
- I have hotter fires burning on my desk.
- If I am not running this business 70 hours a week, I will not have anything to do.
- Our key employees will stay forever and are not worried about future control of the business.
- I do not mind my estate paying 50% of my net worth in estate taxes.
- My children that are active in the business want me to stay in control and in charge forever.

The situation described below is all too common. Does this apply to you? If any of these things apply to you, it is time to work a succession and exit plan.

- Mr. Jones is approximately 60 years old. He is the founder of a highly successful business.
- Over the past 30 years, he worked tirelessly in his business, but he has not developed a succession or exit plan. He always figured he had time and would get to that planning at a later date.
- He always dreamed of turning the reins over to his son to take the business to the next level.
- He looks forward to spending more time at the beach and on the golf course.
- A substantial amount of his personal net worth is in the business; therefore, he could not just gift it away and continue to live in his current lifestyle.

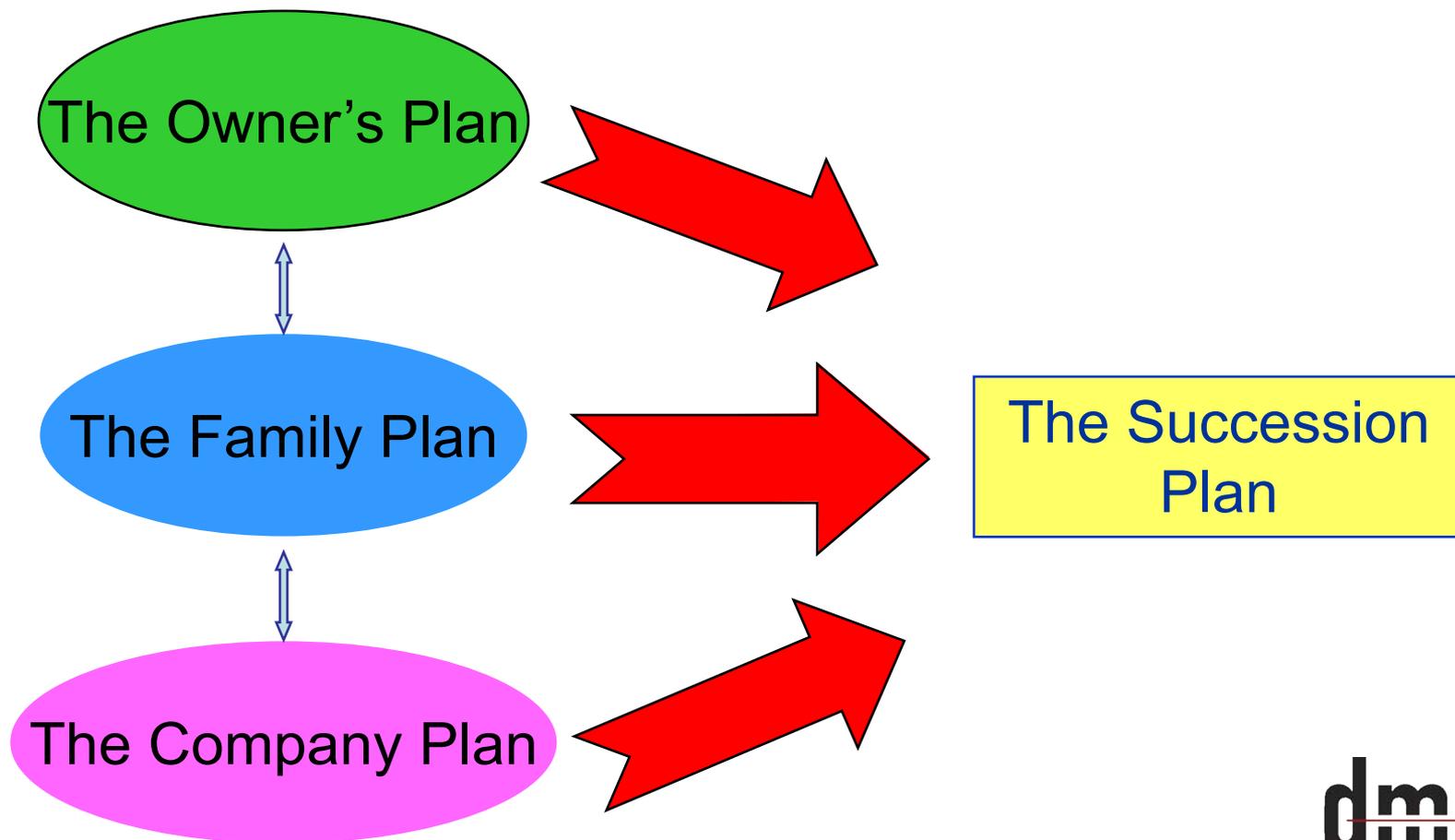
- His son does not have the financial ability to outright buy the business from him, and the bank would require his personal guarantee to loan that amount of money to his son. With a guarantee, even after an outright sale of the business to his son, he would be relying on the future success of the business for his personal financial security.
- His high net worth causes concerns about future estate taxes and he worries his business may have to be sold to pay estate taxes which would be at a time that would not maximize the business's value.
- He has three children and only one of them is active in the business. If the family business all ends up with his one son, he is worried how he can be fair to the other children in terms of inheritance.
- There are many long-term key employees in the business that are not family members and they are expressing some concern over whether the business has a succession plan.

If any of this sounds a bit familiar, then start the process now.

Four Plans are Required

- ✓ The business owner's personal financial plan and estate plan
- ✓ The business's forward-looking strategic plan
- ✓ The family's plan if the business is family owned
- ✓ The succession plan

The Four Parts of Succession Planning for the Privately-Held Business



It all Starts with a Personal Financial Plan for the Business Owner

- ✓ What is your current role as an owner and what would you like your role to be in the future?
- ✓ How much income do you desire from the business in the future and for how long?
- ✓ Do you have sufficient retirement savings outside the business?
- ✓ Consider substantially increasing qualified plan savings as you prepare for a business transition.
- ✓ How long do you want to stay actively involved or how long do you want to maintain control?

It all Starts with a Personal Financial Plan for the Business Owner

Is the real estate in a separate entity or can it be separated from the operating entity to give the business owner long- term rental income even after their active involvement in the business ends?



The Family's Plan

- ✓ How do family relationships affect the business?
- ✓ How is business information shared with family members?
- ✓ How can family members pursue their personal career goals through the business?



The Business Plan

- ✓ What is the strategic plan for the business forward looking beyond the owner's retirement?
- ✓ What are the current and projected financial trends for the industry?
- ✓ Are we operating out of the right entity for our future plans?

C corporation

S corporation

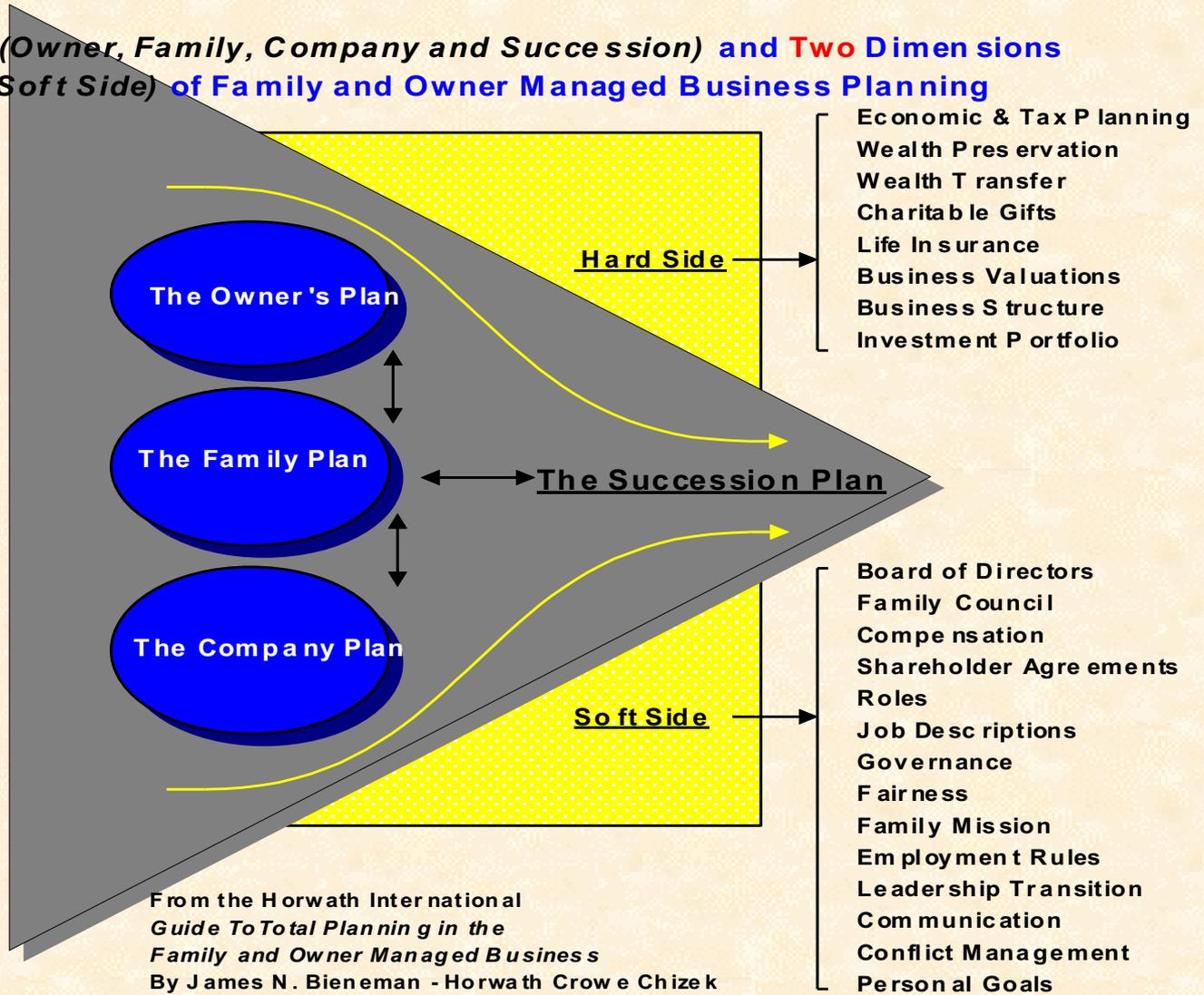
LLC (partnership)

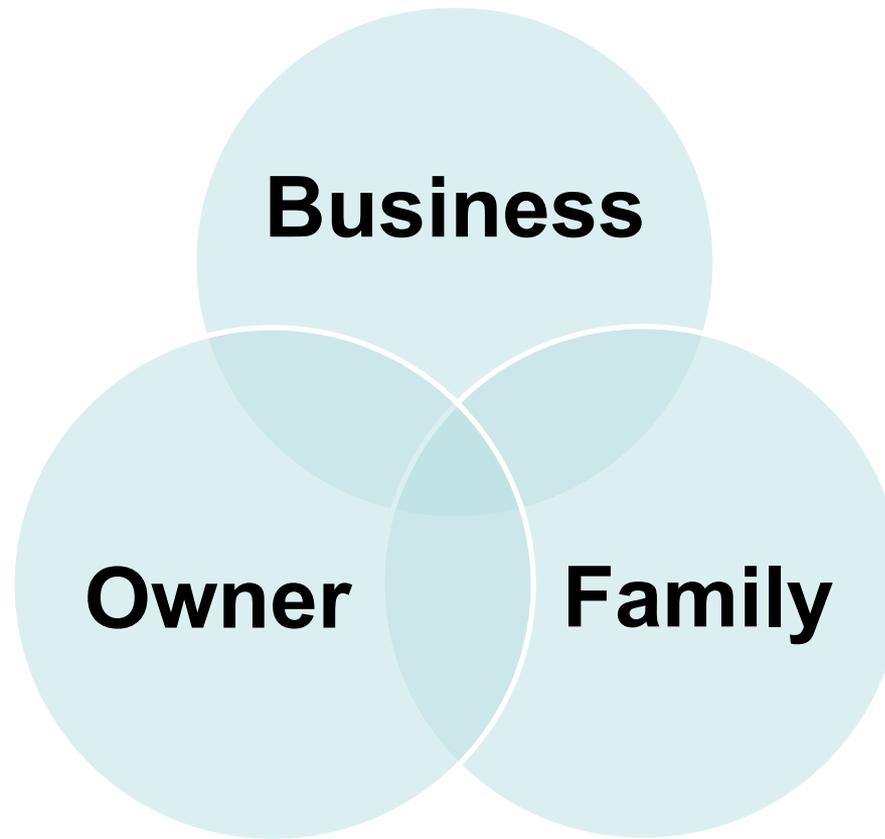
The Business Plan

- ✓ Is the real estate in the right entity separated from the operating entity?
- ✓ Do we need to formalize the governance structure of the entity?
 - Establish a “real” Board of Directors
 - Establish corporate officer accountability and compensation structure that rewards achievement

This is How We Bring it all Together

The Four Parts (Owner, Family, Company and Succession) and **Two Dimensions** (Hard Side and Soft Side) of Family and Owner Managed Business Planning





- Hard Side Issues of Family Business Succession Planning
- Tools and Techniques

Owner Issues

1. Financial Security
2. Wealth Preservation and Transfer with as little Estate Taxes as possible

Family Issues

1. Fairness of Compensation among Family Members involved in the Business
2. Fairness of Inheritance among All Family Members
3. Ownership/Management of Family Business by all Family Members or Limited to Those Involved in the Business

Business Issues

1. Tax Advantaged Structure to Get Earnings Out to Owners
2. Settled Leadership and Ownership Issues

Are we Operating out of the Right Entity?

You must carefully consider all the advantages, disadvantages, eligibility, and tax consequences of each entity before making a decision to change the form of entity under which your business operates.

The presentation only gives a general overview.

C Corporation, S Corporation, or LLC?

The main advantage of an S corporation is that it is a flow-through entity with one level of taxation.

- ✓ Distribute earnings to its shareholders without a double tax on the dividends paid. Retained earnings in excess of those needed to operate the company can be distributed to the shareholders and then invested personally by the shareholders.
- ✓ You can continue to receive distributions with one level of tax and be retired from active participation in the business.

C Corporation, S Corporation, or LLC?

| C Corporation | | | 2013 | 2014 | 2015 | Total |
|-------------------------------|--------------|--------|----------------|----------------|----------------|------------------|
| Net Income | | | 750,000 | 750,000 | 750,000 | 2,250,000 |
| Corporate tax | | | | | | |
| | Federal | 34.00% | 242,250 | 242,250 | 242,250 | 726,750 |
| | NC | 5.00% | 37,500 | 37,500 | 37,500 | 112,500 |
| | Total | | 279,750 | 279,750 | 279,750 | 839,250 |
| Net income after tax | | | 470,250 | 470,250 | 470,250 | 1,410,750 |
| Dividends paid | | | 300,000 | 300,000 | 300,000 | 900,000 |
| Shareholders tax on dividends | | | | | | |
| | Federal | 20.00% | 60,000 | 60,000 | 60,000 | 180,000 |
| | Investment | 3.80% | 11,400 | 11,400 | 11,400 | 34,200 |
| | NC | 5.75% | 17,250 | 17,250 | 17,250 | 51,750 |
| | Total | | 88,650 | 88,650 | 88,650 | 265,950 |
| Total tax paid | | | 368,400 | 368,400 | 368,400 | 1,105,200 |

C Corporation, S Corporation, or LLC?

S Corporation

| | | | <u>2013</u> | <u>2014</u> | <u>2015</u> | <u>Total</u> |
|---|--------------|--------|----------------|----------------|----------------|------------------|
| Net Income | | | 750,000 | 750,000 | 750,000 | 2,250,000 |
| Corporate tax | | | 0 | 0 | 0 | 0 |
| Net income after tax | | | 750,000 | 750,000 | 750,000 | 2,250,000 |
| Shareholders tax on S corporation earnings | | | | | | |
| | Federal | 39.60% | 297,000 | 297,000 | 297,000 | 891,000 |
| Assume material participation | Investment | 0.00% | | | | |
| | NC | 5.75% | 43,125 | 43,125 | 43,125 | 129,375 |
| | Total | | <u>340,125</u> | <u>340,125</u> | <u>340,125</u> | <u>1,020,375</u> |
| Dividends paid | | | 300,000 | 300,000 | 300,000 | 900,000 |
| Shareholders tax on dividends | | | | | | |
| | Federal | 20.00% | 0 | 0 | 0 | 0 |
| | NC | 5.75% | 0 | 0 | 0 | 0 |
| | Total | | <u>0</u> | <u>0</u> | <u>0</u> | <u>0</u> |
| Total tax paid | | | <u>340,125</u> | <u>340,125</u> | <u>340,125</u> | <u>1,020,375</u> |
| Difference in tax, less tax as an S corporation | | | | | | <u>(84,825)</u> |

Example of Payroll Tax Savings from an S corporation

Previous Salary

| | | FICA and Medicare Tax | | | |
|-------------|---|-----------------------|---------------|---------------|----------------|
| | | Compensation | Employer | Employee | Total |
| Shareholder | 1 | 400,000 | 12,849 | 14,649 | 27,498 |
| Shareholder | 2 | 585,000 | 15,532 | 18,997 | 34,529 |
| Shareholder | 3 | 380,000 | 12,559 | 14,179 | 26,738 |
| Shareholder | 4 | 450,000 | 13,574 | 15,824 | 29,398 |
| Shareholder | 5 | 475,000 | 13,937 | 16,412 | 30,349 |
| Shareholder | 6 | 525,000 | 14,662 | 17,587 | 32,249 |
| | | <u>2,815,000</u> | <u>83,113</u> | <u>97,648</u> | <u>180,761</u> |

Revised Salary

| | | FICA and Medicare Tax | | | | | |
|-------------|---|-----------------------|---------------------|------------------|---------------|---------------|----------------|
| | | Total | S Corp. Dividend | Compensation | Employer | Employee | Total |
| Shareholder | 1 | 400,000 | 150,000 | 250,000 | 10,674 | 11,124 | 21,798 |
| Shareholder | 2 | 585,000 | 150,000 | 435,000 | 13,357 | 15,472 | 28,829 |
| Shareholder | 3 | 380,000 | 150,000 | 230,000 | 10,384 | 10,654 | 21,038 |
| Shareholder | 4 | 450,000 | 150,000 | 300,000 | 11,399 | 12,299 | 23,698 |
| Shareholder | 5 | 475,000 | 150,000 | 325,000 | 11,762 | 12,887 | 24,649 |
| Shareholder | 6 | 525,000 | 150,000 | 375,000 | 12,487 | 14,062 | 26,549 |
| | | <u>2,815,000</u> | <u>900,000</u> | <u>1,915,000</u> | <u>70,063</u> | <u>76,498</u> | <u>146,561</u> |

Annual payroll tax savings (note this is not a one time but an annual savings)

34,200

Note you must pay reasonable compensation for services rendered. Also note there are has been a constant stream of legislation introduced to eliminate this tax break on S corporation distributions. You should always monitor pending legislation when planning.

LLC's Have Much of the Favorable “Flow Through” Tax Treatment as an S corporation and More Flexibility

A limited liability company (LLC) compared to S corporations or partnerships:

- ✓ Same “flow through” single level of tax
- ✓ Maximum flexibility
- ✓ Limited liability to all members
- ✓ Uncertainty on self employment tax

Tools Used for the Transfer of the Ownership of a Family Business

These are only brief descriptions of some of the various techniques used for transferring the ownership of a family business.

Complete research and analysis must be done to see how they may apply to any individual situation.

There are many advantages and disadvantages that must be explored for each situation.

Stock Gifts

Gifts of stock in closely-held businesses are very common estate tax and succession planning tools:

- ✓ Often majority shareholders will make gifts of stock to their children
- ✓ Stock gifts are valued as of the date of the gift
- ✓ Discounts from the value for minority interest gifts and lack of marketability

Stock Gifts

- ✓ Discounts may allow a transferor to give larger amounts of stock under the annual gift exclusions.
- ✓ These gifts not only remove the stock from the estate of the transferor but also keep all of the future appreciation on those shares out of the transferor's estate.
- ✓ The disadvantages are that the shareholder may want or need to be paid for their stock and the annual gift exclusion being only \$14,000 per person (for 2013) per year does not allow for large gifts without gift tax consequences.

Gift-Splitting by Married Taxpayers

- ✓ If the donor of the gift is married, gifts to donees made during a year can be treated as split between the husband and wife, even if the cash or gift property is actually given to a donee by only one of them.
- ✓ By gift-splitting, therefore, up to \$26,000 a year can be transferred to each donee by a married couple because their two annual exclusions are available. Thus, for example, a married couple with three married children can transfer a total of \$156,000 each year to their children and the children's spouses (\$26,000 for each of six donees).

Taxable Gifts

Even gifts that are not covered by the annual exclusion, and that are thus taxable, may not result in a tax liability. These gifts in excess of the annual exclusions can be applied against your lifetime estate and gift tax exemption

However, to the extent you use this credit against a gift tax liability, it reduces (or eliminates) the credit available for use against the federal estate tax at your death.

Stock Sales

Sales of closely held stock to family members are also common techniques used to transfer the ownership of family businesses.

The tax consequences of both the buyer and seller must be considered.

Sales also transfer the ownership, remove the stock from the estate of the seller and remove future appreciation on those shares from the seller's estate. Types of stock sales are as follows:

Outright Sale

An outright sale of stock to a family member can often have very undesirable tax consequences.

The seller will usually have a taxable capital gain from the sale. The buyer will usually have to pay for the stock in after-tax dollars, creating a double tax on the transfer.

The purchasing shareholder does get a step-up in the basis of the shares purchased, but this will normally only benefit the new shareholder when he or she later sells the stock.

Installment Sale

An installment sale of the stock can be used as well. This may allow the buyer to use any cash flow generated by the stock to make the note payments to the seller.

The interest paid may be deductible by the buyer either as investment interest or trade or business interest, which could lessen the impact of the double tax.

Any remaining balance due to the seller at his or her death is an asset in his or her estate and is subject to estate tax.

Self-Canceling Installment Sale

A self-canceling installment sale is an installment sale in which the seller's right to receive payments terminates upon the death of the seller.

The advantage is that, unlike a normal installment sale, nothing will be included in the seller's estate for any remaining balance on the note receivable from the sale.

These are very useful tools when the seller desires lifetime income but desires to eliminate estate taxes that may result from the asset.

Self-Canceling Installment Sale

Any unreported gain from the sale at the time of the seller's death must be recognized on the estate's income tax return as income in respect to a decedent.

Consideration must be paid by the buyer for the canceling provision.

Grantor Retained Annuity Trust (GRATs) Grantor Retained Unitrusts (GRUTs)

GRATs and GRUTs are techniques for transferring property to family members in trust. By retaining a qualified annuity or unitrust interest, the value of the gift is greatly reduced. Generally, property is transferred to a trust that lasts for a specified period of time that the grantor is expected to outlive.

At the end of the trust term, the property passes to the family member's beneficiaries of the trust.

The value of the gift for gift tax purposes is the fair value of the property reduced by the present value of the retained interest.

Grantor Retained Annuity Trust (GRATs) Grantor Retained Unitrusts (GRUTs)

GRATs can be a very beneficial tool to use with rapidly appreciating closely-held stock because the growth rate of the stock should be greater than the rate used to calculate payments back to the grantor. This would leave a larger amount passing to the beneficiaries.

The disadvantage is if the donor dies before the end of the trust term, the fair market value of the assets reverts back to the estate.

Redemption

A redemption occurs when a corporation buys back its own stock and thereby transfers the proportionate ownership to the remaining shareholders. A corporation can buy back the shares of a majority shareholder and leave a minority shareholder owning the entire corporation.

In a C corporation, this transaction must be very carefully designed to assure the payments to the selling shareholder are taxed as a sale of stock and not as a dividend.

In an S corporation, you may prefer dividend treatment.

Employee Stock Ownership Plan (ESOP)

An ESOP can be a very tax advantageous method for a shareholder to use to sell his closely-held stock.

Generally, a shareholder sells his stock to an ESOP in which all of the full time employees of the company are participants.

The company makes tax deductible contributions to the ESOP. The ESOP uses those funds to pay the selling shareholder for his stock.

Employee Stock Ownership Plan (ESOP)

The selling shareholder can even defer tax on the sale of the stock by reinvesting in other securities.

The stock is then owned by the ESOP and held in trust for the employees as a retirement plan. The company must redeem the employees' shares in cash when they retire.

Charitable Remainder Unitrust (CRUT)

A CRUT can also provide very advantageous tax consequences for transferring closely-held stock. Generally, a shareholder transfers stock to a CRUT. After the stock is transferred, the company can offer to redeem the stock from the trust.

The trust will use the redemption proceeds to pay the grantor a fixed periodic amount for his entire lifetime.

Charitable Remainder Unitrust (CRUT)

The grantor immediately gets a charitable contribution deduction for the calculated remainder interest in the property when it is given to the trust.

The grantor then gets income for his entire lifetime and, at his death, the trust assets go to the charity. After the company redeems the stock, the ownership interest of the corporation is shifted proportionately to the other shareholders.

Family Limited Partnership or Family LLC's

By using a Family Limited Partnership or Family LLCs, property can be transferred to family members at substantial discounts while the donor still maintains control of the property.

In the simplest form, the husband and wife typically transfer property to a limited partnership in exchange for general and limited partnership interests. They then make gifts of the limited partnership interests to family members but retain the general partnership interests.

Family Limited Partnership or Family LLC's

The parents, being the general partners, maintain complete control over the assets of the partnership but can remove substantially all of the value from their estate.

The parents' retention of control qualifies the limited partnership interests for substantial gift discounts.

This works especially well with real estate that is being leased.

Intentionally Defective Grantor Trusts

If a grantor would like the transfer to the trust to be complete for estate tax purposes so the property will not be included in his or her gross estate but incomplete for federal income tax purposes (so the grantor will be taxed on the trust income), they want what's referred to as an "intentionally defective grantor trust."

It is "defective" for income tax purposes, but effective for estate tax purposes.

Advantages of an Intentionally Defective Grantor Trust (IDGT)

Some of the advantages of being considered a defective grantor trust are as follows:

1. The income tax liability for the trust assets may be lower if taxed at the grantor's, rather than the trust's, tax rates. With the compressed income tax rate structure now in effect for estates and trusts, having the grantor taxed on the trust income may create income tax savings.

Advantages of an Intentionally Defective Grantor Trust (IDGT)

2. By causing the grantor to be taxed on the trust income, the value of the trust assets is not diminished by the taxes, thus allowing a greater value to pass to the remainder beneficiaries. This effectively results in a tax-free gift of the income to the trust's remainder beneficiaries.
3. The trust assets and the appreciation of the trust assets after the date of transfer to the trust are removed from the grantor's gross estate. Thus, appreciation on assets transferred to the trust can be shifted to younger generations with minimal transfer tax.

Pass through Estate

A family business can, of course, be transferred through an estate.

- ✓ The disadvantage is that all of the appreciation in the value of the business is taxed in the decedent's estate.
- ✓ The family members inheriting the business get a basis stepped up to the fair market value as of the date of death.

Need for a Shareholder Agreement or LLC Operating Agreement before any Ownership Transfers are Made

✓ Redemption agreement - Corporation as the purchaser

OR

✓ Cross purchase agreement - Remaining shareholder as the purchaser

Need for a Shareholder Agreement or LLC Operating Agreement before any Ownership Transfers are Made

- ✓ Restrict the free transfer of the shares outside the ownership group.
- ✓ Establish how the value will be determined and what triggering events determine when stock will be purchased by the company or other shareholders:
 - Death
 - Disability
 - Termination of employment
 - Bankruptcy of shareholders
 - To prevent shares from being transferred to an ex- spouse in a domestic matter.

Need for a Shareholder Agreement or LLC Operating Agreement before any Ownership Transfers are Made

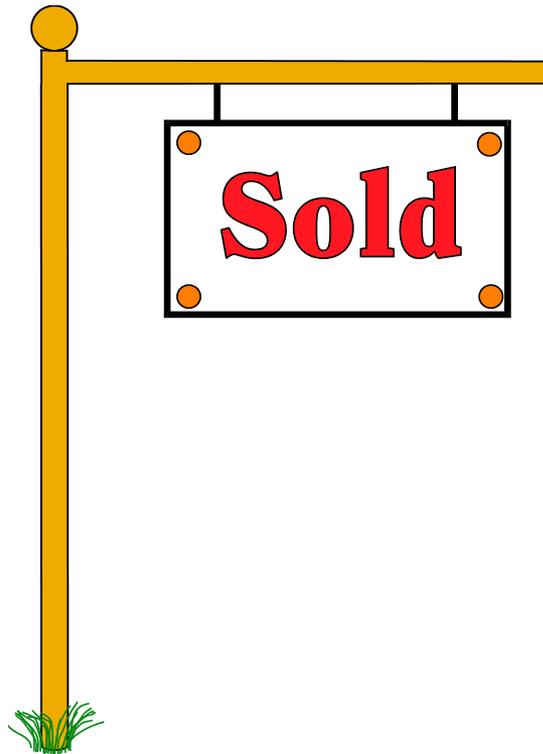
Using life insurance for funding for the stock purchase in the event of death:

- ✓ Keep the continuing entity from being under financial hardship
- ✓ Insure the shareholder's heirs to have the financial benefits replacing the income the shares provided.

Need for a Shareholder Agreement or LLC Operating Agreement before any Ownership Transfers are Made

- ✓ Consider using voting and nonvoting shares or LLC units.

The Succession Plan Could be a Sale of the Company



When is the Right Succession Plan to Sell the Business?

- ✓ When is the right time to sell?
- ✓ Getting the business ready to sell could take 5 years or more.
- ✓ The right entity selection is critical.
- ✓ Identify logical buyers and consider the use of an investment banker or business broker to market the business.
- ✓ Typical valuation models.
- ✓ Asset sale vs. stock sale.

Estate Planning Should be Part of the Succession Planning Process

The airplane crashes - now who is in charge?

In 2013, the exemption equivalent for estate tax purposes is \$5.250,000.

Consider a Life Insurance Trust as a “Make Up” to Those Heirs Not Receiving the Business Assets

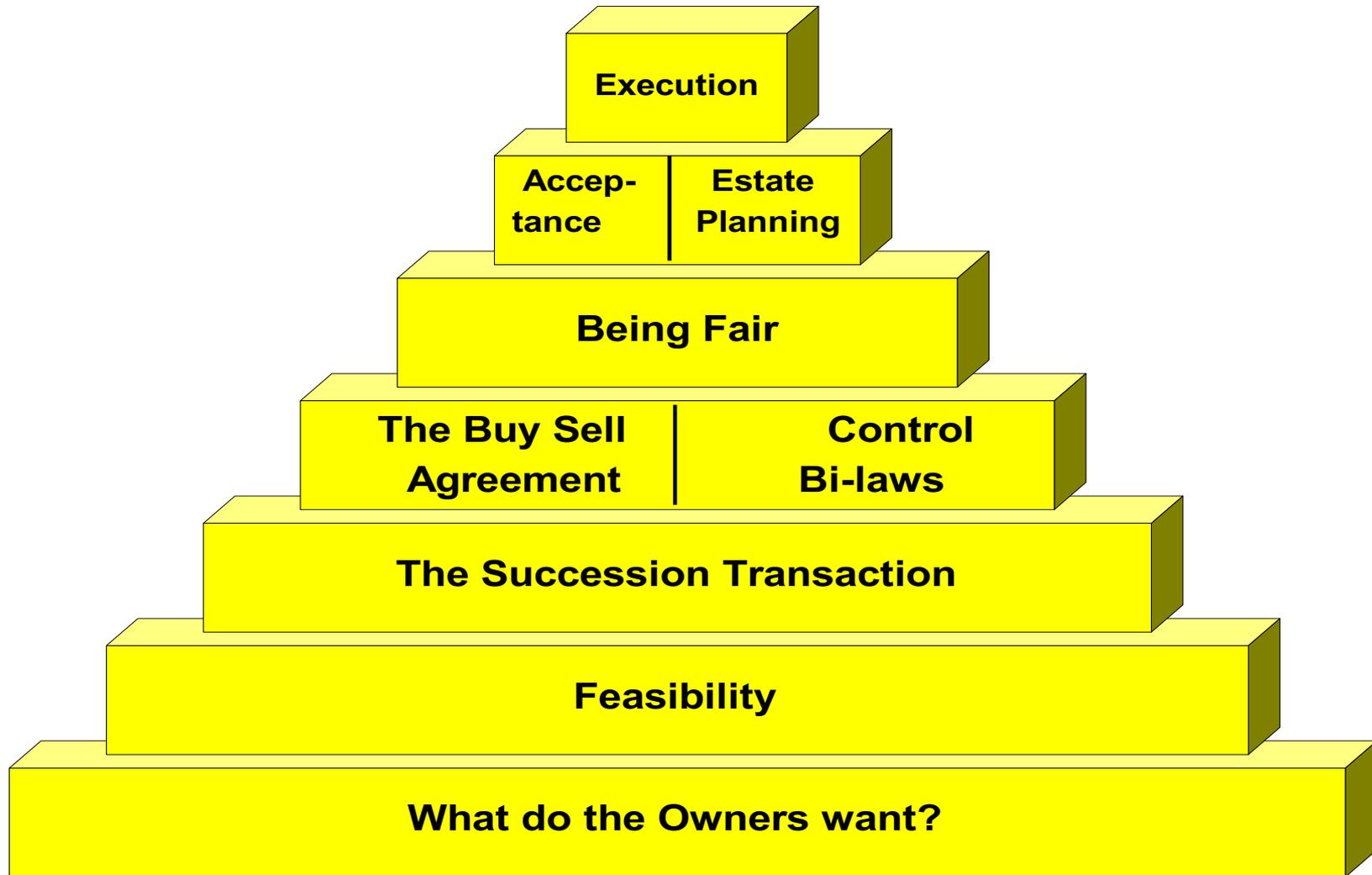
You create an irrevocable life insurance trust to be the owner and beneficiary of one or more life insurance policies on your life.

- ✓ You contribute cash to the trust to be used by the trustee to make premium payments on the life insurance policies.
- ✓ If the trust is properly drafted, the contributions you make to the trust for premium payments will qualify for the annual gift tax exclusion, so you will not have to pay gift tax on the contributions.

Consider a Life Insurance Trust as a “Make Up” to Those Heirs Not Receiving the Business Assets

- ✓ A properly drafted life insurance trust keeps the insurance proceeds from being taxed in your estate as well as in the estate of your surviving spouse.
- ✓ On your death, the trust continues for the benefit of your spouse during his or her lifetime.
- ✓ On the death of your spouse, the trust assets are paid outright to, or held in further trust for the benefit of, your descendants.

The Succession Planning Process



Questions?



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