BUSINESS SUCCESSION STRATEGIES

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ESTATE

PLANNING

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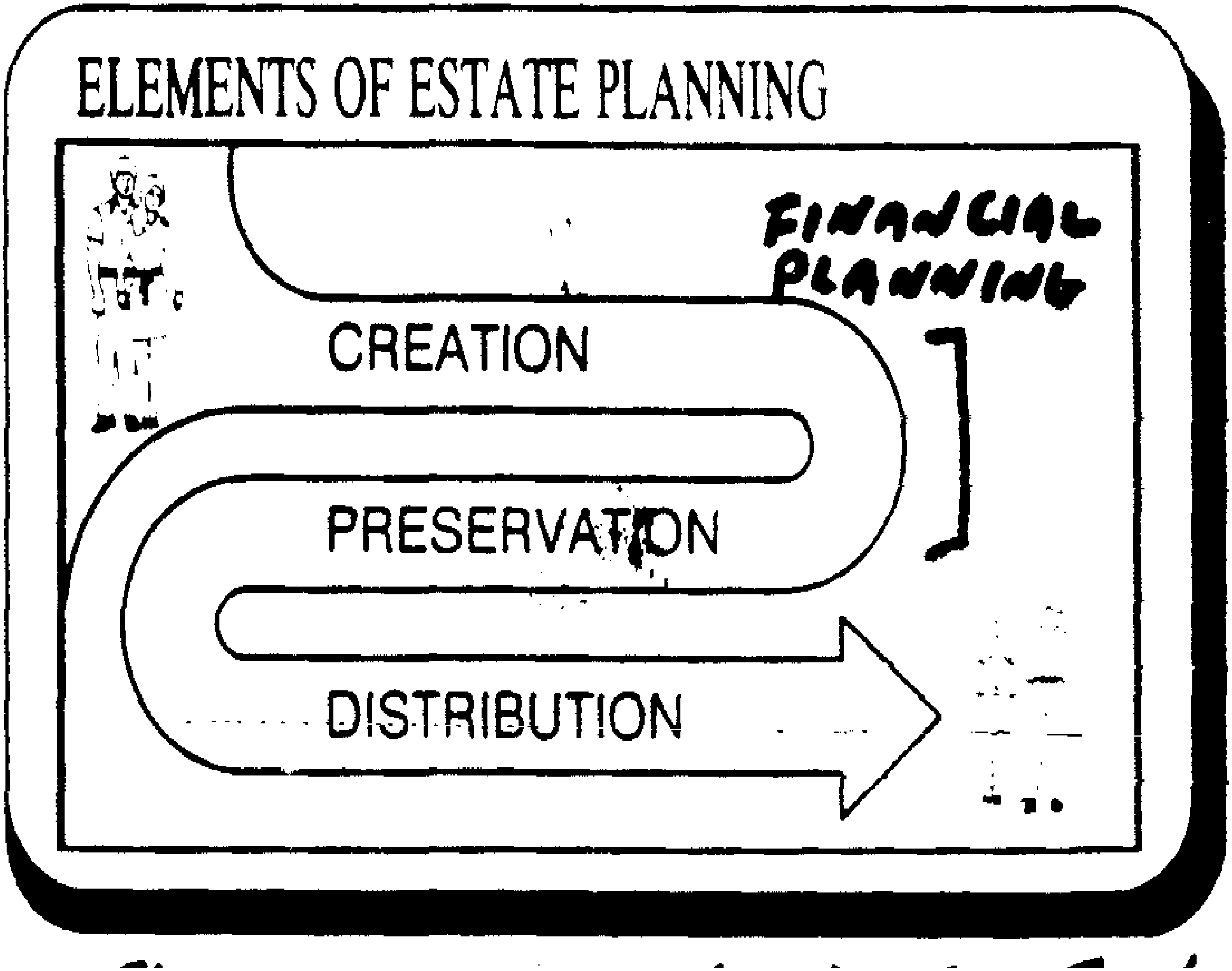
ELEMENTS OF ESTATE PLANNING
FINANCIAL PLANNING
CREATION
PRESERVATION
DISTRIBUTION

I. Problems, Choices and Decisions

1. Will the Business Survive the Owner's Death? If it is a personal service nature, typically it does not.

2. If it can be passed on, should the family assume the business?

3. Are there family members capable of managing the Business? Key employee?

II. Basic Precepts

1. Family members working in the business must be able and hardworking

1. Provide leadership: The owner must promote unity and cooperation among family members.

2. Don’t commingle business with personal dealings: Keep accurate books and records of transactions.

3. Plan for divorce: Enter into a buyout agreement to keep ownership in the family if a family members become divorced.

4. Non-active children: they should not own an interest.

III. Choice of Entity and Valuation Issues

1. IRS method of valuing a business often depends on the form of entity.
2. C-Corp.: double taxation: a. Corp. tax, and b. shareholder dividends
3. S-Corp.: restrictions when trusts are designated as S corp.
4. Family Limited Partnership and Limited Liability Companies:

IV. TRANSFERRING THE FAMILY BUSINESS INTERESTS

1. Gifting it to a family member:

   Annual gift tax exclusion:

   $11,000 (2005); $12,000 (2006) (non cumulative)

2. Unlimited Gift Tax Marital Deduction:

   a. Both spouses are U.S. Citizens: unlimited

   b. Not U.S. Citizen spouse: annual exclusion from gift tax is $116,000 (2005) (code sec. 2523(i)(2)

3. Applicable Exclusion / Unified Credit: Life time cumulative exclusion from tax of $1 million (2002-2009)

V. BUY – SELL AGREEMENT

1. **Objectives**:

   a. Restrict ownership to undesired third parties.

   b. Protect against transfer that can adversely affect an S election, professional corp. status.

   c. Allow a smooth transition

   d. Avoid disputes among owners

   e. Fund the acquisition of a deceased or withdrawing owner's interest

2. Benefits to the owner / transferor

a. Favorable price for an unmarketable asset

b. Readily available cash

c. Avoid a forced sale and pressured price negotiations

d. Establishment of the value of the Business Interest for federal estate tax purpose.

e. Provide a source of income and capital for the surviving spouse and other beneficiaries

3. Types of Buy-Sell Agreements

a. Redemption or Entity Purchase Agreement: The entity purchases the ownership interest

b. Cross-purchase Agreement: Other co-owners purchase the transferor's interest

c. Hybrid agreement: entity purchases the interest and has the right to assign the purchase right to the remaining owners.

4. How Will the Purchase Price be Paid:

a. Cash

b. Installments

   1. appropriate interest rate

   2. secured transaction?

c. Use of life insurance as a funding vehicle

   1. Who owns the policy

d. Use stock or other property to fund the agreement

e. Borrow money to accomplish the buyout

5 Triggering Events for Buy-Sell Agreement:

a. Death

b. Disability

c. Retirement at a targeted age

d. Desired sale to a third pary

e. Desire to “walk away” at any time

f. Insolvency or Bankruptcy of an owner

g. Divorce

- Each event can be optional or mandatory
- Higher price for some events

6. Approaches to Valuation

a. Agreed-upon value (reviewed periodically)

b. Formula (capitalized earnings, weighted average of earning, etc.)

c. Professional appraisal (Fair Market Value – the amount at which property would change hands between a willing seller and a willing buyer)

d. Book value

e. Book value adjusted for appraised value of fixed assets and off balance sheet items (I.e. goodwill)

f. Liquidation Value

7. Establishing the Value of the Business for Estate Tax Purposes

a. Unrelated persons: presumption that value arrived from an arm's – length negotiations

b. Family business: presumption that owners create an artificially low selling price in order to reduce estate tax.

I.R.C. 2703: Value of property is determined without regard to any right or restriction relating to the property, I.e. buy-sell agreement. Will recognize purchase price in the buy-sell agreement if:

(1) bona fide business arrangement

(2) full consideration is used in the buy-sell agreement

(3) terms in the buy-sell agreement are comparable to similar arrangements in an arm's-length transaction.

8. S Corporation Preservation Issues

a. Buy-sell agreement may address that shares can not be transferred to the following:

   corporations, partnerships, nonresident aliens, and certain trusts

b. S corp. are not permitted to have a 2nd class of stock, agreement may prohibit execution of various instruments: options, certain loans, convertible notes (equivalent to 2nd class of stock) (diff. Voting rights are ok)

c. The agreement should provides that transfer to an eligible shareholder is immediately void.

9. Liquidity Issues in Family Business Succession Plan

a. Source of Liquidity - Decedent's Own Funds: pay estate tax, expenses, debts, etc.

b. Source of Liquidity – Life Insurance: excellent source of liquidity and through use of an irrevocable life insurance trust (ILIT), not part of the decedent's estate.

I.L.I.T. is a common estate planning instrument used in conjunction with life insurance policies. We can have a separate private session regarding this subject for those who are interested.

(1) Redemption type Buy-sell:

Corp.= policy owner + bene or

estate = bene (to avoid corp, creditor)

Premium not tax deductible (IRC 264(a)(1))

(2) Shareholder cross-purchase type of buy-sell: each shareholder must obtain a life insurance on all the other shareholders

Disadvantage: large number of policies must be obtained if there are many shareholders.

Premium not tax deductible (IRC 264(a)(1))

c. <u>Sources of Liquidity</u>: The Business Interest Itself.

(1) If a C Corp., distributions will be taxed as dividends

(2) Stock redemption by decedent's estate: possible capital gain tax. Also, if a redemption does not alter the stock ownership of the company, it is taxed as a dividend.

(3) ESOP – Employee Stock Option Plan. Owner sellls his shares to the ESOP trust.

Disadvantages: the ESOP allows a broad range of employees to an ownership interest in a family-controlled corporation.

d. Source of Liquidity- Code section 303 Redemption to pay death taxes

   Requirement: 35 or greater percentage of decedent's gross estate is comprised of the stock in business.

e. Code Section 6166 Installment payments – 5 year deferred payment of estate tax available if decedent was a U.S. citizen or resident and decedent's interest in a closely-held business exceeds 35% of the value of the decedent's gross estate.

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