Basic Strategies to Protect the Family Business

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Introduction

Most Family Businesses fail to transition to the next generation

- Lack of planning for estate taxes
- Failure to address family Issues
- Failure to transition management

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Planning Considerations

Estate Taxes

- Federal: 40% tax rate over exemption
  - $11,400,000 Exemption (2019)
  - Portability – Elect to use the unused exemption of deceased spouse
- Maine: 8-12% tax rate over exemption
  - $5,700,000 Exemption (2019)
  - No Portability
- Annual Exclusion:
  - $15,000 per person per donee (2019)

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Planning Considerations

Family Issues

- Provide retirement income to owner and spouse
- Fair allocation of assets among operating and non-operating children
- Avoid aggravating sibling divisions
- Maintaining family control of the business

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Planning Considerations

Transition of Management

- Recognizing and fostering capability
- Clarity of succession to key employees, family and lenders
- Allow operating children to manage business without interference from owner or non-operating children
- Do operating children have credibility with employees? The eldest is not always the right choice.

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Planning Considerations

Family Harmony/Marketplace Demands

- Strive for equal treatment but recognize talent
- Does the business get sold to preserve family harmony?
- Who does the attorney represent?

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Planning Considerations

Training a new generation of Owners

- Start early/determine interest of children in business
- Business Degree?
- Delegation/increasing responsibility
- Employment Contract?
- Transfer of Stock? When?
- Be mindful of employees
- Retention of Key Employees

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Planning Considerations

Tensions between Retired Owners and Children operating the Business

- Retirement income
  - Installment sale/Consulting agreement
  - Qualified Retirement Plans
  - Deferred Compensation
  - Lease of Real Estate
- Sufficient working capital
- “Can’t let go”/non-interference

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Techniques for Transferring Ownership

Evaluating Business Assets

- Assets
  - Tangible business assets such as equipment and inventory
  - Intangible business assets such as trademarks, copyrights, patents and Goodwill
  - Real Estate

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Techniques for Transferring Ownership

Evaluating Business Liquidity

- Liquidity
  - Working Capital/Current Ratio
  - Sufficient cash flow to support buy-out?
  - Business owned Life Insurance
    - Key Person
    - Available for redemption upon death?
    - Cash Value

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Techniques for Transferring Ownership

Life Insurance

- Creates Liquidity
- Is the Owner insurable/Cost?
- Avoid inclusion in Owner's estate
- How much insurance and what type?

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Techniques for Transferring Ownership

Life Insurance/Disability Insurance

- Fund purchase by operating children
- Fund equalizing bequests to non-operating children through Irrevocable Life Insurance Trust
- Disability Insurance
  - Income Replacement
  - Fund buy-out?

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Techniques for Transferring Ownership

Voting and Non-Voting Stock

- Transfer voting stock to operating children
- Transfer non-voting stock to non-operating children
- Perception of equal treatment but not an ideal long term solution
  - Income from business versus sale of stock

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Techniques for Transferring Ownership

Lifetime Gifts versus Testamentary Transfers

- Advantages
  - Maximizing valuation discounts
  - Minimizing liquidity problems at death
  - Shift income/Retain Income
  - Gifts may be structured to maintain control
  - Use of Annual Exclusion ($15,000 per person per year)
  - Gift tax paid removed from estate

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Techniques for Transferring Ownership

Lifetime Gifts versus Testamentary Transfers

- Disadvantages
  - Carryover Basis versus Stepped Basis at Death
  - Possible Loss of Income
  - Possible Loss of control

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Techniques for Transferring Ownership

Annual Exclusion Gifts

- Currently, $15,000 per person per year
  - Gift splitting with spouse – IRC 2513(a)
  - Year end/New Year gifts – use of one valuation
  - Gifts of Non-Voting/maintenance of control
  - Gifts of stock to operating children/Gifts of LLC interests (real estate) to non-operating children
- Must be a present interest, not future interest
- Can make Taxable Gifts

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Techniques for Transferring Ownership

Lifetime Transfers – Installment Sale

- Gain recognized as payments are received
- Can use low interest rate (AFR)
- Purchaser gets cost basis
- Loss of Control by Seller

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Techniques for Transferring Ownership

Lease of Business Assets

- Business owned by operating children
- Real Estate owned by non-operating children
- Structure Lease to minimize conflicts
- Fair Rental Value
- 5 year options/Option to Purchase

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Techniques for Transferring Ownership

Mandatory Buyout of Non-operating Children

- Operating and Non-operating children own stock
- Fair market value purchase
- Assumes sufficient liquidity at death of owner
- Long Term note for amount not paid in cash

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Shareholder Agreements

Benefits of Shareholder Agreements

- Restrict transfers of stock/maintenance of control
- Facilitates Continuity of Management
- Can fix the value of the business among all shareholders and for estate tax purposes
- Provides payment terms and liquidity for Sellers

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Shareholder Agreements

Transfer Restrictions

- Preferable to restrictions in Articles/Bylaws
  - Power to amend – supermajority or unanimity
- Tailored restrictions
  - Family members
  - Key employees
  - Outsiders
- Contractual Triggers for Transfers

Shareholder Agreements

Transfer Restrictions – S Corporations

- Prevent Transfers to Ineligible Shareholders
  - Multi-member Limited Liability Companies (LLCs)
  - Non-Resident Alien
- Only Certain Trusts eligible as S Corporation Shareholders
  - Grantor Trusts
  - Voting Trusts
  - Testamentary Trust for 2 years
  - Electing Small Business Trust – ESBT
  - Qualified Subchapter S Trust – QSST

Shareholder Agreements

Continuity of Management

- Can require transfer of stock by disabled, retired or deceased shareholder
- Can require transfer of stock by non-operating children

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Shareholder Agreements

Fixing Value of the Business

- Objective: Agreed upon value is binding on other parties to the Shareholder Agreement and the IRS
- Objective: Minimize emotional and financial difficulties of ownership transition
- Objective: Minimize risk to business from disputes

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Shareholder Agreements

Cross Purchase versus Redemption

- Cross Purchase Agreement: Each business owner has an obligation to buy out each other owner
- Redemption: The Company has an obligation to purchase the interest of a selling owner
  - Can be in Bylaws or Articles or in separate agreement

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Shareholder Agreements

Advantages/Disadvantages of Cross Purchase and Redemption

- Basis: Cross Purchase will increase a buyer's basis by purchase price. Redemption does not increase basis
- Tax Treatment of Payments: Generally, capital gains treatment but can be dividend in a Redemption under IRC 302
- Only one Buyer in Redemption

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Shareholder Agreements

Funding with Life Insurance

- Redemption:
  - Only one policy on each Owner
  - Premiums not deductible
  - Proceeds subject to AMT with C Corporations
- Cross Purchase:
  - Each Owner has policy on every other Owner
  - Only policy on each Owner if owned by Trust but be careful of Transfer for Value rule and death benefits in excess of purchase obligation

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Shareholder Agreements

Payment of Purchase Price

- Immediate Payment to the extent of available insurance proceeds (Disability or Life)
- Balance paid with promissory note
  - Interest Rate and Term
  - Balloon Payment
  - No Prepayment Penalty
- Security
  - Mortgage
  - Stock Pledge

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Shareholder Agreements

Valuation Discounts

- Can enhance gifting strategies
  - Annual Exclusion Gifts
  - GRATS/Installment Sales
- Included in Fair Market Value (unless excluded)
- Types of Discounts
  - Lack of Marketability
  - Minority Interest
  - Built in Gain

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Employee Stock Ownership Plan (ESOP)

What is an ESOP?

- A qualified retirement plan that is entitled to own Employer securities – IRC § 4975(e)(7)
- Exception to the "prohibited transaction" rules under ERISA – would not otherwise be allowed because it is a transaction among related parties
- Subject to ERISA and IRC and the joint jurisdiction of the US Department of Labor and IRS

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Employee Stock Ownership Plan (ESOP)

Why use an ESOP?

- Borrow at reduced after-tax cost
- Reduce or eliminate federal income tax at both corporate and shareholder levels
- Solve ownership succession issues
- Provide employees with incentives for productivity

Employee Stock Ownership Plan (ESOP)

What are Qualified Employer Securities?

- Common stock having the greatest dividend and voting rights.
- Can be preferred stock if it is non-callable and convertible into qualifying common stock

Employee Stock Ownership Plan (ESOP)

Important Employee Rights

- Employees can require employer to redeem the employer stock in their ESOP account when they retire or are otherwise entitled to a distribution from the ESOP
- Employees who are 55 and have 10 years of service have right to diversify out of employer stock
- These rights give rise to Employer's "repurchase liability" (should be in pro-forma projection)

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Employee Stock Ownership Plan (ESOP)

Using ESOP with a C Corporation

- Advantages:
  - Selling Shareholder can defer capital gains by reinvesting in "qualified replacement property"
  - C Corporation may be able to deduct certain dividends
  - With a "Leveraged ESOP", both interest and principal on the loan can be deductible to the C Corporation
- Disadvantages:
  - C Corporations are subject to double taxation (somewhat mitigated by 2017 tax act)

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Employee Stock Ownership Plan (ESOP)

Leveraged ESOP (See Diagram on next page)

1. Lender makes loan to ESOP
2. Company guarantees the loan
3. ESOP uses loan proceeds to acquire Seller's Stock
4. Seller transfers stock to ESOP
5. Company makes annual deductible contribution to ESOP
6. ESOP uses company contribution to repay loan

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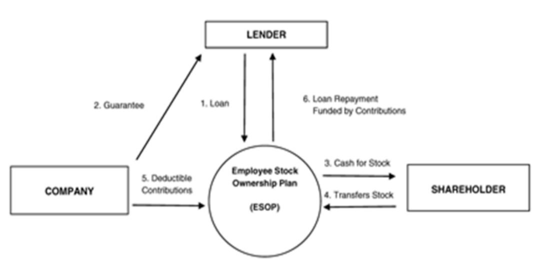
Employee Stock Ownership Plan (ESOP)

Leveraged ESOP



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Using ESOP with a S Corporation

Employee Stock Ownership Plan (ESOP)

- Advantages:
  - ESOP's share of S Corporation income is not taxed because it is a tax-exempt entity
  - Value of distributed shares is "cost basis", not fair market value
- Disadvantages:
  - Selling Shareholder cannot defer taxes by investing proceeds in "qualified replacement property"
  - No deductions for dividends paid
  - No deduction for contribution to pay loan

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"Net Redemption" ESOPs

Employee Stock Ownership Plan (ESOP)

- Corporation redeems stock of selling shareholder for a promissory note
- Value of Corporation is diminished by Note
- Corporation issues stock to ESOP at low value
- Corporation's payments of principal to former shareholder increase equity
- Former shareholder can act as safety valve if corporation has economic problems (note can be extended, deferred, etc.)

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Employee Stock Ownership Plan (ESOP)

Ideal Candidates for ESOPs

- Corporations with low debt and strong cash flow
- Corporations with strong management team in place after buy-out
- Corporations with recurring business and low exposure to reliance on one or two customers

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Employee Stock Ownership Plan (ESOP)

Preliminary Steps for consideration of ESOP

- Commission an ESOP study with experienced ESOP consultant
- Involve Corporation’s accountant and counsel
- Education on roles of parties involved in ESOP and potential conflicts of interests

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