

TRANSITIONING THE FAMILY BUSINESS

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BUSINESS SUCCESSION PLANNING

Statistics on Failure of Family Businesses

- **17 Million Privately Owned, Full Time Businesses v. 25,000 Publicly Traded Companies**
- **Only 115,000 Businesses with Over 100 Employees**
- **Privately Owned Businesses represent 99% of all of U.S. Businesses, employ almost 60% of the workforce, and generate almost 60% of the GDP**
- **Ownership of Family Businesses is aging rapidly, with almost 1/3 of all family business owners over the age of 61**

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BUSINESS SUCCESSION PLANNING

Statistics on Failure of Family Businesses

- **Statistics from a 2003 American Family Business Survey indicate that over 53% of small business owners and CEO's do not plan for the transfer or succession of the business on their death.**
- **According to leading researcher Joseph Astrachan, former editor of the Family Business Review for the Family Firm Institute, the unavoidable result of this lack of planning is that**
 - **over 70% of small businesses fail in the generation following the death of the founding owner**
 - **approximately 90% fail to continue in the third generation**

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BUSINESS SUCCESSION PLANNING

Unintended consequences of no succession plan

1. Lack of defined management upon death of owner
2. Lack of sufficient funds/liquidity
3. Family conflicts
4. Loss of value in assets/business
5. Failure to provide for loved ones
6. Loss of key employees/partners
7. Complete failure of the business on death of owner

Remember: no succession plan is still a plan—it is usually just a bad one!



BUSINESS SUCCESSION PLANNING

Roadblocks to Succession Planning

1. Procrastination
2. Cost considerations
3. Conflicts with family members/ partners
4. Questions of capacity of Owner
5. Desire to retain control



TYPES OF SUCCESSION PLANNING

1. Estate Planning

- Minimize Estate and Income Taxes
- Paying Estate Taxes
 - Liquidation plans
 - Ensuring liquidity
 - Extending payments to pay through income
- Choosing the heirs/manner of distribution



TYPES OF SUCCESSION PLANNING

2. Succession Planning

- Selling or liquidating the business
- Sale of decedent's interest to family, partners, or employees
- Transitioning to the next generation
- Assuring the continuity of the business or preservation of value

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TYPES OF SUCCESSION PLANNING

3. Retirement Planning

- Providing funds for the owner in retirement
- Transferring the owner's interest
- Planning for incapacity/disability

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CONFLICTING VALUES AND INTERESTS: THE FAMILY VERSUS THE BUSINESS

- Family Values
 - Providing wealth transition
 - Providing maximum income for spouse
 - Retaining control over business
 - Paying estate taxes

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CONFLICTING VALUES AND INTERESTS: THE FAMILY VERSUS THE BUSINESS

- **Business Values**
 - Retaining clients/customers
 - Profitability
 - Avoiding liquidation
 - Providing security/employment for employees

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CONFLICTING VALUES AND INTERESTS: THE NEEDS OF OWNER VS. NEEDS OF BUSINESS

- **Owner's Goals and Interests:**
 - Retirement security
 - Retention/transition of power
 - Providing for spouse/loved ones
 - Succession to future generations
 - Payment of Estate taxes
 - Stability of business

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CONFLICTING VALUES AND INTERESTS: THE NEEDS OF OWNER VS. NEEDS OF BUSINESS

- **Business's Goals and Interests:**
 - Preservation of assets
 - Expansion of business
 - Provision for/retention of employees
 - Long term growth
 - Maximizing profits for partners

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IDENTIFICATION OF KEY ISSUES

1. Lifetime Transfers vs. Transfers on Death

LIFETIME TRANSFERS	TRANSFERS ON DEATH
Structured transition of management	Retention of control by owner
Owner's control over process	Potentially cheaper to set up plan (short term)
Identification of problems prior to death	Estate planning advantages
Greater chance of succession to next generation	Less conflict during lifetime of owner
Easier resolution of family disputes	
Participation of others - acceptance of transition	
Flexibility to change goals	

IDENTIFICATION OF KEY ISSUES

2. Long-Term Goals vs. Short-Term Goals

LONG-TERM GOALS	SHORT-TERMS GOALS
Profitability of business	Providing liquidity of owner's estate
Growing the business after the owner dies	Providing for the surviving spouse/retirement of owner
Preserving the business to future generations	Transitioning the business to the next generation

IDENTIFICATION OF KEY ISSUES

3. Involvement of the Spouse

ACTIVE SPOUSE	NON-ACTIVE SPOUSE
Acceptance of spouse by employees/partners	Providing for income
Expertise/qualifications to manage the business	Limiting spousal involvement/control
Possibility of undue influence	

IDENTIFICATION OF KEY ISSUES

3. Involvement of the Spouse

Protecting family interests and preserving for
future generations

- Possible liquidation/sale of business by spouse
- Potential remarriage by spouse
- Mechanisms to protect interests for children
 - Use of Trusts
 - Forfeiture clauses
 - Conversion of interest to limited partner/preferred stock

IDENTIFICATION OF KEY ISSUES

4. Analysis of the Children

How to Distribute the Ownership Interest?

- Managing vs. Non-Managing Children
- Distributing ownership equally
 - Problems of sibling rivalry
 - Active vs. Non-Active children
 - Training children to take over the business
 - Mechanisms for resolving disputes
- Providing for Non-Active children through other assets/limited financial interests

IDENTIFICATION OF KEY ISSUES

4. Analysis of the Children

Divorce/Creditors

- Prenuptial agreements
- Use of trusts
- Limitation of transferability of interest

IDENTIFICATION OF KEY ISSUES

4. Analysis of the Children Dealing with Minor Children

- Incapability of ownership interest
- Planning for their inclusion in the business
- Planning techniques



IDENTIFICATION OF KEY ISSUES

5. Planning for Creditors/Lenders/Suppliers

- Avoiding foreclosure/calling the note
- Paying claims of creditors
- Assigning/transferring personal guarantees
- Maintaining relationships and contracts



IDENTIFICATION OF KEY ISSUES

6. Succession Planning for Multiple Owners Representation of Multiple Partners

- Ethical concerns
- Representing the business itself



IDENTIFICATION OF KEY ISSUES

6. Succession Planning for Multiple Owners Conflicts between Family and Partners

- Personality conflicts – the forced partnership
- Differing values
- The fight for control

SUCCESSION PLANNING FOR PARTNERS

6. Succession Planning for Multiple Owners Identification of Interests/Problem Areas

- Valuation of business interests
- Control
- Expertise
- Tax implications
- Capital, liquidity, funding problems
- Participation in business by heirs

SUCCESSION PLANNING FOR PARTNERS

6. Succession Planning for Multiple Owners Structuring the Succession – Before Death

- Buyout provisions
- Buy-Sell Agreements
- Liquidity and the role of insurance
- Review/revisions to the Operating Agreement or Bylaws
- Preparing for the family partnership

SUCCESSION PLANNING FOR PARTNERS

6. Succession Planning for Multiple Owners Structuring the Succession – After Death

- Review of Operating Agreement or Bylaws
- Dealing with the family partnership
- Problems with finding liquidity for the buyout



TRANSITION TO THE NEXT GENERATION: STRUCTURE OF TRANSACTION

The Structure of the transition depends on the answers to the many issues raised in the prior slides, but it usually results in the selection of one of the following options:

- Intra-family Gifts and Sales (including sales to intentionally defective grantor trusts)
- Redemption
- Sales to Partners / Other Owners
- Sales to Outside Third Parties



TRANSITION TO THE NEXT GENERATION: Intra-Family Gifting

Intra-Family Gifts

- Gifting of interests in a business is always an option in intra-family situations. Usually the easiest option.
- Tax Treatment
- Advantages
- Disadvantages
- Valuation Issues



TRANSITION TO THE NEXT GENERATION: Intra-Family Sales

Intra-Family Sales

- Selling of a business interest is another option in intra-family situations.
- Tax Treatment
- Advantages
- Disadvantages
- Valuation Issues (to be addressed)

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TRANSITION TO THE NEXT GENERATION: Sales to an IDGT

Sale to an Intentionally Defective Grantor Trust.

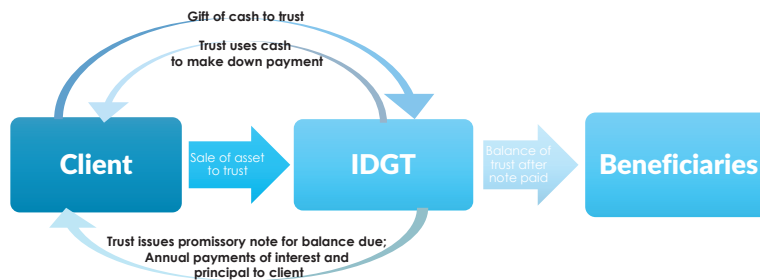
- Another option is to sell the Owner's interest to an intentionally defective grantor trust.
- What is an IDGT?
- Result of an IDGT
- What provisions may be added to make a trust "intentionally defective?"

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SALE TO INTENTIONALLY DEFECTIVE GRANTOR TRUST (IDGT)



ADVANTAGES:

- Not a sale for income tax
- During Grantor's life, Grantor pays income of trust for beneficiaries benefit w/out gift tax
- Basis increased to payments on note
- Slightly lower interest rate
- Cash flow should be able to cover the note
- Arrangement does not fail if Grantor dies during term of note
- Client continues to receive cash flow, no income tax on interest
- Transfer for gift and estate tax purposes
- GST

DISADVANTAGES:

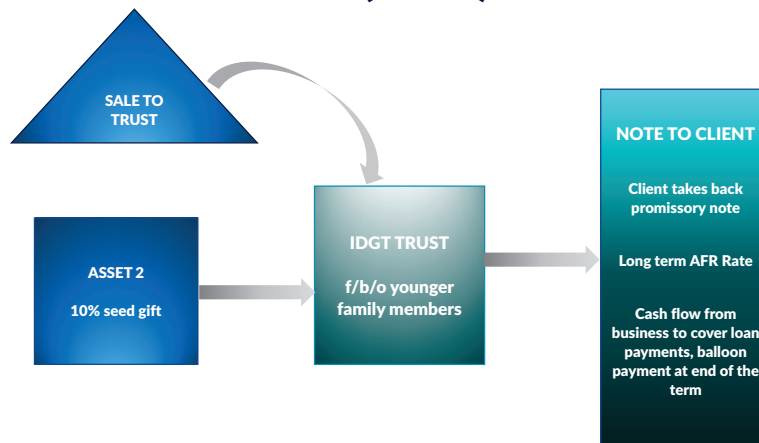
- Need 10% seed money for initial gift
 - Could trigger gift tax immediately
- Not a statutorily approved vehicle
- Income tax recognition to estate if Grantor dies during term of the trust
- Trust loses Grantor Trust status upon Grantor's death

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SALE TO INTENTIONALLY DEFECTIVE GRANTOR TRUST (IDGT)



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TRANSITION TO THE NEXT GENERATION: Redemptions and Cross-Purchases

Redemption / Cross Purchase

- For situations where liquidity is an issue, an Owner may consider having the Company redeem his interest, or entering into a binding agreement to have another partners or Owner purchase his interest upon death.
- Can be utilized for both intra-family transfers and transfers to unrelated owners.
- This planning tool is usually put into place through use of a buy sell agreement....

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BUY-SELL AGREEMENTS

- What is a buy-sell agreement?
- Trigger provisions – including the following
 - Voluntary transfers
 - Retirement
 - Termination of employment
 - Death
 - Involuntary transfers, divorce, bankruptcy

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BUY-SELL AGREEMENTS

- **Benefits of a buy-sell agreement**

- To the surviving owners
- To the deceased's estate and family
- To both!



BUY-SELL AGREEMENTS

- **Types of Buy-Sell Agreements**

- Cross purchase
- Redemption
- Hybrid
- Wait-and-See

- **Advantages and Disadvantages**



BUY-SELL AGREEMENTS

Income Tax Issues

- Entity Type
- Characterization
- Basis
- Conflicting goals



BUY-SELL AGREEMENTS

C Corporation Issues

- **Entity purchase – Redemption**
 - **Section 302 applies – general rule is redemption will be treated as distribution**
 - **Exceptions to 302 – key planning tool for obtaining sale or exchange treatment**
 - **Taxability on corporation**
 - **No taxes on distribution**
 - **Section 311 applies to distribution of appreciated property**
 - **Reduction of E&P**

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BUY-SELL AGREEMENTS

C Corporation Issues

- **Cross purchase**
 - **Ease of Administration**
 - **Increased Basis**
 - **Problems of Liquidity**

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BUY-SELL AGREEMENTS

S Corporation Issues

- **Entity Purchase**
 - **Same rules as C-Corp – Section 302 applies**
 - **Different accounting issues for S-Corp distribution – Section 1368**

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BUY-SELL AGREEMENTS

- **Cross Purchase**

- Sale or Exchange treatment for purchase
- Increased basis of shareholders in purchased stock

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BUY-SELL AGREEMENTS

- **Other issues for S-Corp redemptions and purchases**

- One class of stock requirement – Reg. 1.1361-1(l)(2)(iii)(A)
- Election to close books (Section 1377)

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BUY-SELL AGREEMENTS

Partnerships

- **Entity purchase**

- Redemption under Section 736
- 736(a) versus 736(b) payments
- Section 751(b) – the Hot Assets rules

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BUY-SELL AGREEMENTS

Partnerships

- **Cross Purchases**
 - **Section 731 sale or exchange**
 - **Hot assets – Section 751 – Special rule for inventory**
 - **Application of Section 741 to remaining accounts**



BUY-SELL AGREEMENTS

Partnerships

- **754 Election**
 - **Result of disparity between outside basis and inside basis**
 - **754 allows adjustment of these bases to avoid double tax**
 - **708(b)(1)(B) – exception to the rule for sale of 50% within 12 months**



BUY-SELL AGREEMENTS

Methods of Determining Purchase Price

- **Fixed dollar**
- **Book value**
- **Certificate of value**
- **Appraisal value**
- **Agreed upon value**



BUY-SELL AGREEMENTS

Valuation Issues

- Fair market value – Reg. Sec. 20-2031-1(b)
- Methods of valuation include the following methods:
 - Discounted future returns
 - Capitalization of earning
 - Industry rules of thumb
 - Asset value
- Revenue Ruling 59-60 – seminal IRS guidance on valuation
- Importance of case law



BUY-SELL AGREEMENTS

Discounts to Valuation

- Lack of marketability
- Minority
- Control premium
- Unique factors of the business



BUY-SELL AGREEMENTS

Estate Tax Issues

- Key issue: Will IRS recognize the valuation?
- Estate freeze
- Treatment depends upon the year of agreement



BUY-SELL AGREEMENTS

For Pre-1990 Agreements, the following rules apply:

- Reg. Section 2031-2(h)
- Four factor approach from cases
 - Obligation of estate to sell stock at fixed price
 - Reasonable and ascertainable price for the stock
 - No sale by decedent at greater price
 - The BS agreement is not a device to transfer the business interests to the natural object of the decedent's bounty for inadequate consideration
- Very subjective tests - *Estate of True v. Commissioner*, T.C. Memo 2001-167, *aff'd* 94 AFTR 2004-7039 (10th Cir. 2004)

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BUY-SELL AGREEMENTS

- For Post-1990 Agreements, have to take into account IRC Section 2703
- Section 2703 adds requirements
 - Modification of device test
 - Comparable agreements - need for expert testimony
 - Safe harbor - Reg. 25.2703(1)(b)(3)

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BUY-SELL AGREEMENTS

- Significant cases on Section 2703
 - *Smith III v. U.S.*, 94 AFTR 2d 2004-5283 (W.D. Pa 2004)
 - *Estate of Blount v. Commissioner*, T.C. Memo 2004-116, *aff'd* 428 F. 3d 1338 (11th Cir. 2005)
 - *Estate of Amlie v. Commissioner*, T.C. Memo 2006-76
 - *Holman v. Commissioner*, 130 T.C. No. 12 (2008), *aff'd* 105 AFTR 2d 2010-1802 (8th Cir. 2010)

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BUY-SELL AGREEMENTS

Additional Estate Tax Issues?

- Effect on marital deduction—PLR 9147065
- Effect on annual exclusion—Hackl v. Commissioner, 335 F.3d 664 (7th Cir. 2003)
- Estate tax deferral - IRC 6166

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BUY-SELL AGREEMENTS

Funding of the Buy Sell Agreement

Insurance is by far the most common way to fund buy sell agreements, as it provides the necessary liquidity for purchase with the greatest tax advantages.

- Benefits of Funded Buy-Sell Agreement
- Insurance Ownership
- Income Taxation issues
- Transfer for value rules
- Cross purchase arrangements

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BUY-SELL AGREEMENTS

Other methods of funding

- Lump Sum (possibly using a sinking fund)
- Deferral
 - Income tax issues
 - Estate tax issues (Section 6166)
 - Issues of security
- Borrowing money from third parties

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TRANSITION TO THE NEXT GENERATION: Sales to Third Parties

- The final option for transitioning a business is selling the business to an unrelated third party.
- Can involve other individuals or companies, a competitor, private equity group, or even the employees themselves (through an ESOP)
- Usually no problem in agreeing to payment plan for interest, since Buyer is unrelated.
- Problem—limited market for buyers of small family businesses



TRANSITION TO THE NEXT GENERATION: Sales to Third Parties

Forms of Transaction

1. Stock / Membership Interest Sale

- Easiest option
- Usually results in capital gain (lowest taxes on sale)
- Buyer takes all company liabilities
- Estate taxes—lose ability to discount value



TRANSITION TO THE NEXT GENERATION: Sales to Third Parties

Forms of Transaction

2. Asset Purchase

- More complex option—much more documentation
- Can be a mixture of ordinary income and capital gain, and can result in double tax for C Corporations
- Seller usually retains all or some of company liabilities
- Sale of goodwill can be corporate or personal—complex issue, especially for professionals



FACT PATTERN

Clients are Davida (56 years old) and Theo (60 years old) Fenway, who are married with two adult children, a son Dustin and daughter Marianna.

Five years ago, Davida sold her successful public relations firm for \$8,000,000

A year later, Theo's grandfather Yawkey passed away and left Theo publicly traded stock worth \$10,000,000

Davida & Theo consulted an estate planner and implemented a gifting program which resulted in each of them using approximately \$3,500,000 of their respective exemptions



FACT PATTERN

Three years ago, Theo, Dustin and Marianna began a specialized on-line sports information business, Beantown Services, LLC

Theo believes Beantown will grow at a rapid rate and become extremely attractive to a public company within five years

Theo, Dustin and Marianna each owns 1/3 of Beantown

Davida and Theo consulted with their planner to discuss the transfer of Theo's interest in Beantown before an anticipated increase in value



FACT PATTERN

Davida & Theo would like to avoid exhausting their remaining gift tax exemptions

They also would like to receive some value for the transferred interest but exclude appreciation from their estates

What are their options?



FACT PATTERN

Number 1: Gift his Interest

Gift of interests in a business is always an option in intra-family situations. Usually the easiest option.

- Tax Treatment
- Advantages
- Disadvantages
- Valuation Issues
- Meet their goals?
- Potential for Conflict?



FACT PATTERN

Number 2: Sell his interest to one or more of the children

Selling his interest to one or more family members is also an option.

- Tax Treatment
- Advantages
- Disadvantages
- Valuation Issues
- Meet their goals?
- Potential for Conflict?



FACT PATTERN

Number 3: Redemption of his interest by the Company

Redemption by the company or other owners is an option. Can either be a redemption or a cross-purchase agreement with the other members.

- Tax Treatment
- Advantages
- Disadvantages
- Valuation Issues
- Meet their goals?
- Potential for Conflict?



FACT PATTERN

Number 4: Sell his Interest to an IDGT

- Tax Treatment
- Advantages
- Disadvantages
- Valuation Issues
- Meet their goals?
- Potential for Conflict?



FACT PATTERN

Number 5: Sale to a third party

- Tax Treatment
- Advantages
- Disadvantages
- Valuation Issues
- Meet their goals?
- Potential for Conflict?



CHECKLIST FOR SUCCESSION PLANNING

- See materials for a comprehensive checklist for succession planning issues
- Checklists are important in this area, for both assistance in planning and for professional liability



QUESTIONS?

THANK YOU!!!

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