Mind Your Own Business:

Succession Planning For The Closely Held Business

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Family Business Survival

- 80% of all businesses are family businesses (37% of Fortune 500, 60% of public companies)
- Family businesses employ 60% of labor force (1999 figure)
- 30% will succeed to 2nd generation; 12% to the 3rd generation, 3% to the 4th generation
- Average business life is 24 years
- 39% of family businesses will change hands in next 5 years
- Why succession often fails:
  - Inadequate estate planning
  - Lack of succession planning
  - Estate taxes
- 25% of older generation business owners don't engage in estate planning

Shirtsleeves to Shirtsleeves in Three Generations

- The first generation produces the wealth
- The second generation preserves the wealth BUT creates no new wealth
- The third generation spends the wealth
- “Rice paddies to rice paddies in three generations” – Japan
- “The father buys, the son builds, the grandson sells, the great-grandson begs” - Scottish proverb

Avoiding the Sleeveless Generation

- Creating Respect for Elders – telling the story and creating a family business history
- Create an expectation of achievement – a culture of excellence is expected
- Have intergenerational conversations – set a time each year and give each person an assignment
- No free lunch – joining the family business is not automatic
- Understanding that wealth is more than money – community obligation and “paying forward”

How Can You Transition Your Business?

What Are Your Choices?

1. Family Members
   A. Are they involved?
   B. Are they trained?
   C. Are they interested?
   D. Treating the kids equally

2. Partners
   A. How long with the Company?
   B. How old are they?
   C. Are they interested?

3. Key Employees
   A. How old are they?
   B. Are they trained? Have they been empowered?
   C. Are they interested and capable?

4. The Public Market – IPO, Sale, Merger

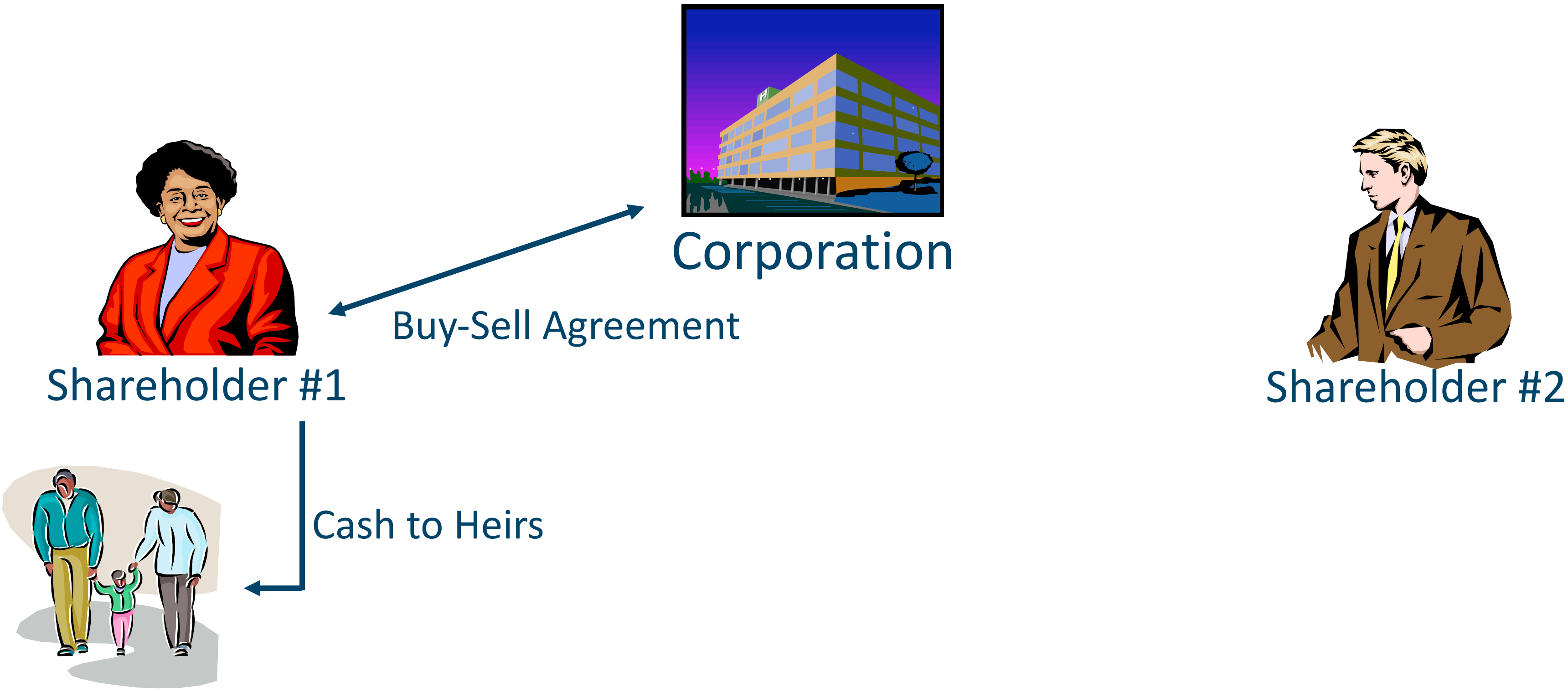
5. Turn out the lights

Based on your choice, how do you best position your business for that transition?

Establishing Objectives

- Provide orderly transition of ownership upon occurrence of specified events
  - Death
  - Disability
  - Retirement
  - Bankruptcy
  - Divorce
- Prevent conflict between heirs or other outsiders and those continuing the business
- Provide an orderly liquidation of a withdrawing business owner
- Creating a market for shares
- Fixing the value for estate and gift tax purposes
- Providing cash to pay death taxes and other estate settlement costs

Corporation Redemption Method



- Corporation agrees to purchase shares of deceased Shareholder #1
- Shareholder #2 then owns 100% of Corporation

Caution: If not structured properly, the purchase price may be treated as a taxable dividend to the extent of the Corporation's current or accumulated earnings and profits. Most often a problem in family sales.

Cross-Purchase Method

Corporation

Shareholder #1 ← Buy-Sell Agreement → Shareholder #2

Cash to Heirs

- Surviving Shareholder #2 purchases shares of deceased Shareholder #1
- Shareholder #2 then owns 100% of Corporation

Tax Basis Considerations

Assumptions

- Corporation worth $1,000,000
- Two equal shareholders - $500,000 equity each
- Cost basis of $250,000

Redemption Method

- Corporation purchases deceased shareholder's shares for $500,000
- Surviving shareholder owns corporation worth $1,000,000
- Cost basis of surviving shareholder still $250,000
- Sale of corporation by survivor results in capital gain of $750,000

Cross-Purchase Method

- Surviving shareholder purchases shares for $500,000
- Surviving shareholder owns corporation worth $1,000,000
- Cost basis of surviving shareholder is $750,000 ($250,000 basis of original shares plus $500,000 for purchased shares)
- Sale of corporation by survivor results in capital gain of $250,000

What's It Worth?

SETTING THE PURCHASE PRICE

7. Minority and Lack of Marketability Discounts

- Impact on price due to lack of voting control and absence of a ready market
- Rarely considered by unrelated parties
- Often used in family sales to reduce gift and estate tax consequences

8. Control Premium

- Does voting control of a business add value?
- How much?

9. Goodwill (Blue Sky)

- Benefits resulting from location, reputation, trademarks and other intangibles
- One of the most difficult items to value
- Always considered more valuable by the departing owner

SETTING THE PURCHASE PRICE

1. **Fixed Price**
   - ▶ Parties agree on price in the Agreement and update annually
   - ☺ Advantage: True-bargained for price updated by participants
   - ☹ Disadvantage: Parties rarely update
2. **Book Value**
   - ▶ Cost of assets on company books less depreciation depletion and liabilities (net worth)
   - ☺ Advantage: Easily determined by CPA
   - ☹ Disadvantage: Does not reflect "true" value of appreciated assets
3. **Adjusted Book Value**
   - ▶ Net worth with specified adjustments to take into account appreciated assets, bad debt write-offs, etc.
   - ☺ Advantage: Reduces distortions of book value
   - ☹ Disadvantage: Does not reflect value of key-man, goodwill and intangibles

SETTING THE PURCHASE PRICE

4. Capitalization of Earnings

- ▶ Historical earnings x a suitable capitalization rate to reflect future value of an income stream
- ☺ Advantage: Evaluates future growth potential
- ☹ Disadvantage: Picking appropriate capitalization rate. Assumes past performance property forecasts future performance

5. Recent Sales

- ▶ What shares have sold for in recent transactions
- ☺ Advantage: Presumes past sales are indication of the future market
- ☹ Disadvantage: Does not account for family sales or distress sales where such factors distort value

6. Appraised Value

- ▶ Determination by independent qualified appraiser
- ☺ Advantage: All of the most appropriate factors for this company are used
- ☹ Disadvantage: Selecting the appraiser. Difficulty of knowing the value at any given time without reappraisal

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Financing the Purchase
(How do we pay the departing owner?)

1. Cash – usually not enough liquid assets available without damaging the day-to-day business operations
2. Installment Note
   - Interest rate to avoid imputed interest determined by IRS tables
   - Owner's family at risk that business may fail
   - Securing the note with personal guarantees, pledge of shares, restrictions on payment of dividends and salaries
3. Corporate Sinking Fund
   - Setting aside a certain amount in a special account each year – what if I die too soon?

1. Life Insurance
   - Often the most predictable and least expensive funding method
   - Guaranteed availability of the money exactly when needed
   - What if insurance proceeds exceed the purchase price?
   - Purchase by surviving owner of policy on his/her life

Setting Estate Tax Values

(IRS Code Sections 2703 and 2031)

- Buy-Sell Agreement may set value for estate tax purposes if:
  - Agreement is a bona fide business arrangements(e.g., continuity of management)
  - Not a device to transfer property to family members for less than adequate consideration in money
  - Terms are comparable to similar agreements between unrelated persons
  - Restricts transfer during life and at death
  - The estate is required to sell at death
  - The selling price is fixed or calculable according to a formula or another reasonable method

Estate of Madeline F. McGill

Valuation of Wright & McGill Co. (T.C. Memo 1984-292)

	Class A Shares	Class C Shares
Value Reported on 710	$10.00 / share	$10.00 / share
IRS Valuation* (*Estate tax deficiency = $5,595,018)	$901.10 / share	$27.71 / share
Boettcher and Company Valuation	$7.81 / share	$7.81 / share
Standard Research Associates Valuation	$4.55 / share	$4.55 / share
Tax Court Valuation	$12.00 / share	$10.00 / share

Solving the Multiple Shareholder Cross-Purchase Agreement

- Four Shareholders would require 12 life insurance policies to fund a cross-purchase agreement
- Trusteed plan requires only four policies
- The multiple cross-purchase agreement requires surviving Shareholders to purchase deceased Shareholder interest proportionately
- Independent trustee of life insurance escrow trust collects death benefit and distributes cash proportionately to surviving Shareholders

Solving the Multiple Shareholder Cross-Purchase Agreement