

Special Edition

Successor Planning Part 10

Over 9 weeks, I've discussed "easing" out of the business and how to transfer the business from one generation to the next. I discussed;

- Establishing a Successor Plan.
- How to choose a Successor?
- How to begin the process of planning succession of your business?
- How to transfer ownership?
- How to implement the process of "passing the baton"?

I discussed selecting competent advisors to assist you in the process.

- I reviewed buy/sell agreements.
- Private annuities;

This week, I want to focus on various types of trust documents, tax free organizations, as well as ESOP programs.

There are various trusts that can be set up to assist you in transferring assets to the next generation. I'm not going to dwell on the various trusts because some of the trusts are;

- Very complicated.
- You need to develop your exit goals and objectives before you choose the type of trust you want, but;
- I will touch on several ways to transfer assets.

GRANTOR RETAINED ANNUITY TRUST (GRATS)

A GRATS is a complex method of transferring assets to the next generation and reducing estate and gift taxes. GRATS are essentially fixed annuities that move appreciating assets out of your estate over a number of years.

These kinds of trusts can be useful for estate planning in family business succession – especially if a future public offering, will likely raise share values. GRATS are a way to make gifts, and transfer the fair market value of assets, on a discounted basis, since only part of the gift gets valued in an irrevocable trust.

There are specific cautions involved in these types of trusts, and I would encourage you to review them with a competent tax and estate planning professional.

MANAGEMENT CONSULTING
OPERATIONAL REVIEWS • MERGERS • ACQUISITIONS • DIVESTITURES

THE AHERN ADVISORY

in this issue

Successor Planning
Part 10



Ahern & Associates, Ltd.

Accredited Member
National Bureau of Certified
Consultants Inc.

August 11, 2009

Re-capitalization, or the insurance of 2 classes of corporate stock, is another method used to transfer ownership at a minimal tax cost. **Stock is generally divided into voting and non-voting categories**, which permits control to remain with one individual or group; usually the family members who are active in the business.

- The non-voting stock is used to provide equity to the inactive family members, but;
- There are stringent laws limiting recapitalization, so, again, expert legal advice is advised.

If a business owner chooses a gift of only non-voting stock prior to his/her death, this allows the owner to reduce the value of the estate without affecting control. By making gifts with non-voting stock, the growth in that stock will occur in the hands of the next generation – rather than in the hands of the current owner. **This essentially “freezes” the value of the owner’s interest in the company as the stock continues to grow in value** after the date of the gift. Using the gift tax annual exclusion, the transfers can be made tax free; subject to limitations.

The tax code spells out specific rules that apply when businesses utilize this type of “estate freeze” technique. Under the tax code, at least 10% of a firm’s value must be attributed to the “junior equity”.

There are also Tax Free Organizations. If you have a C or an S Corp and another corporation is an interested buyer, and you need to do a stock deal, tax free reorganization may be an option. The general rule is that shareholders must recognize taxable gains when they dispose of their shares. **However, under Tax Free Reorganizations, the tax code allows share holders to defer gains.**

Tax Free Reorganization means that, neither you as a selling shareholder, the target corporation, nor the corporate Buyer recognizes any taxable income. You will receive stock in the acquiring corporation and those shares will be taken on the tax basis of your shares in the company you are selling. **Not until you sell the new shares, are you required to recognize the “built in” capital gain**, inherent in your old shares.

Another area that has gained popularity, but has some pitfalls, is Employee Stock Ownerships Plans (ESOP’S):

- If your company is a C or an S Corporation that is profitable, you might want to consider an ESOP as a possible tax free exit strategy.
- **An ESOP is a type of qualified retirement plan set up for your employees, much like a profit sharing or 401K plan.**
- **The purpose of the ESOP is to allow company employees to obtain part, or all of the stock of their employer through a trust agreement.**
- **The trust actually owns the stock and is managed by a trustee, appointed by the board of directors.**
- **As employer, your corporation is allowed to make tax deductible contributions to the ESOP, and there is no current taxable income to the ESOP participant (your covered employees).**

A unique aspect of ESOPS is that they can borrow money from the corporation, shareholders or third party lenders. That money can then be used by the ESOP, as leverage, to acquire their initial batch of employee share from you, the owner.

There are several impressive tax advantages. There are even tax breaks that can benefit you, personally. However, there are also some pitfalls:

- Once you enter an ESOP program:
- If the program does not work out to your benefit, and;
- You try to sell your business, the ESOP is entitled to have their own administrator and it makes it very difficult to sell your business, because if the employees don’t understand/accept the true value of your company, at the time you want to exit, you may be stuck with a non-performing asset – your business.

Assuming that you have decided that:

- You don’t want to sell to family members.
- You don’t want to sell to employees.
- You can then go to the outside market.

Potential Buyers, for your firm, can be customers, competitors or other family operated businesses. Generally, they can be described as one of the following;

- **Financial Buyers** (who's motivated by cash flow, holding companies, or individuals with money to invest).
- **Strategic Buyers** (those with a genuine interest in incorporating your company into theirs, such as a competitor or a company related business).
- **Insiders** (friends who know your business).

It is important to understand that you get one chance to put a “price tag” on your years of personal investment. I cannot stress to you enough that you need competent advice to make such an important decision. **9 out of 10 times;**

- A Seller over prices his/her company.
- He/she lets their emotions get in the way.
- **They don't understand what the market is willing to pay at a given time for their business, and;**
- They make specific demands that eliminate a major portion of the marketplace.

For example; in the trucking industry, 60% - 70% of trucking companies, (today), are sold utilizing an asset sale formula;

- The Buyer will not purchase the stock of the company, but;
- There are specific tax treatments that can be utilized to reduce some of the tax exposures, but;
- If you demand a stock sale, you are eliminating 60% - 70% of the current marketplace.

It's important to understand that trucking is a unique business and it doesn't follow other business models;

- Trucking is a cyclical business.
- It's a pennies business, and;
- **In trucking, 3 things have to happen date of acquisition:**
 - a) The company needs to cash flow, date of acquisition.
 - b) Service debt, and;
 - c) Have a return on investment.

Other businesses can wait 5 – 7 years before the owners have a return on their investment, but trucking does not follow those formulas.

Next week will be my final series on Successor planning; I will be discussing “timing” a sale, “putting a value” on your business, evaluations, and how to add “value” prior to the sale of your business.

QUOTE OF THE WEEK: “It doesn't matter what you are trying to accomplish. It's all a matter of discipline”.