BUSINESS SUCCESSION ISSUES

Jason Melville, J.D., LL.M. Taxation
jmelville@hawleytroxell.com
(208) 388-4971

HAWLEY TROXELL
ATTORNEYS AND COUNSELORS

BACKGROUND

- Hawley Troxell Ennis & Hawley, LLP
- Speaker

Jason Melville, J.D., LL.M. Taxation

- Estate and Estate Tax Planning, Probate, and Trust Administration
- Business
- Tax planning and tax disputes

HAWLEY TROXELL
ATTORNEYS AND COUNSELORS

BACKGROUND

This handout and the speaker's presentation are for informational and educational uses only and are not intended to be and should not be used or relied upon as a substitute for specific legal advice on specific matters. If legal advice is required, the services of a qualified attorney should be sought.

SUCCESSION ISSUES

General Thoughts:

-70% of family-owned businesses fail or are sold before the second generation gets a chance to take over.

-Just 10% remain active for the third generation.

-Many family businesses have the same leaders for 20+ years.

HAWLEY TROXELL
ATTORNEYS AND COUNSELORS

SUCCESSION ISSUES

General Thoughts (cont.)

-Why do they fail? No successor, no market, no financing, no training and grooming, no plan, death or disability, taxes.

-It's tough going from 0-60 in a short time frame.

SUCCESSION ISSUES

Barriers to Planning:

-Too busy.

-Assumptions on succession options – it will work out.

-Too complicated.

-Ego.

-Cash flow.

HAWLEY TROXELL
ATTORNEYS AND COUNSELORS

THE SUCCESSION PLAN

General Issues:

-It’s a process, not a 1 and done.

-There is no one solution for everybody.

-It’s your life, your business, your wealth, possibly your legacy, so plan for it.

THE SUCCESSION PLAN

General Issues (cont.):

-It’s a business – you must be profitable.

-It’s a business – you must have good management; common to have 1 or few managers which can make transition difficult.

-It’s a business – you must have a good team.

THE SUCCESSION PLAN

General Issues (cont.):

-You have to communicate and be clear about goals/desires – i.e., the business is more than a child's plan B; may not support everyone; parity/fairness issues.

-Clarity about decision making and involvement of key players/family in those decisions.

THE SUCCESSION PLAN

Identifying the Successor:

- Outside sale.
- Key employee/player.
- Family sale/transfer.
- ESOP

THE SUCCESSION PLAN

Identifying the Method of Transfer (Point A to Point B):

- Bequest at death.
- Lifetime sale.
- Lifetime gift.

THE SUCCESSION PLAN

Techniques/combinations:

1. Bequest at death

- Want an in-house transfer
- Not worried about estate taxes
- Get income tax step-up
- May have untrained/uninterested heir
- Fairness issues
- Could be structured as sale from estate

THE SUCCESSION PLAN

Techniques/combinations:

2.Sale – assets or equity

- In general, an asset sale creates income taxes based on capital gain (goodwill) and ordinary income from most assets.

- In general, a stock/equity sale creates income taxes based mainly on capital gain; there may still be some ordinary income from depreciation and other re-capture items.

THE SUCCESSION PLAN

3.Buy-Sell Agreement Buy Out

- Used for in-house sales and to restrict out of house transfers among existing owners.

- Pre-arranged sale price formula and buy-out terms – price closer to FMV is best.

- Can be used for exit events – death, disability, retirement.

THE SUCCESSION PLAN

3. Buy-Sell Agreement Buy Out (cont.)

- Can utilize life insurance to fund it.
- Can be used to tie people in with buy out terms, non-competes

THE SUCCESSION PLAN

4.Gifting

- Gift of equity in the business entity to family members; usually the entity is structured to provide non-voting interests and those are gifted. Non-voting interests have diminished value. Could also be sold.
- You cannot gift to non-family members = compensation income.
- A buy/sell agreement is advised.

HAWLEY TROXELL
ATTORNEYS AND COUNSELORS

THE SUCCESSION PLAN

5. Sale to Grantor Trust

- Owner/grantor creates an irrevocable trust that is designed to be a "grantor trust" i.e. treated as the grantor for income tax purposes.
- Owner seeds the trust with cash equal to 10% of the anticipated purchase price. This 10% is a gift to trust beneficiaries (owner children).

HAWLEY TROXELL
ATTORNEYS AND COUNSELORS

THE SUCCESSION PLAN

5. Sale to Grantor Trust (cont.)

- The trust buys owner's equity at FMV typically on a secured note; sale is treated as sale to oneself = no income tax.

- The note requires at least applicable federal rate of interest. The note requires payments so you need to have cash flow.

HAWLEY TROXELL
ATTORNEYS AND COUNSELORS

THE SUCCESSION PLAN

5. Sale to Grantor Trust (cont.)

- The note remains as part of the owner’s taxable estate but future appreciation has been passed to the trust and on to children.
- Can be combined with discounted equity entities.

THE SUCCESSION PLAN

6. Sale to ESOP

- A sale of stock to an employer funded retirement plan – a trust.

- If the company is a C corporation and other rules are met, the seller can defer taxable gain on the sale of stock to the plan by rolling over proceeds to other qualified stock; no deferral of gain for S corporation stock sale.

HAWLEY TROXELL
ATTORNEYS AND COUNSELORS

THE SUCCESSION PLAN

6. Sale to ESOP (cont.)

- Creates a buyer for the stock which is sold to the plan for appraised FMV.

- Seller may sell stock over time – sell at least 30% for C corporation gain deferral.

- Involves employees as “owners” – they have a plan retirement account that holds their share of company stock.

HAWLEY TROXELL
ATTORNEYS AND COUNSELORS

THE SUCCESSION PLAN

6. Sale to ESOP (cont.)

- Typically seen with larger privately held companies that can fund the plan; an ESOP cannot hold publicly traded stock.
- Can cost $200,000+ to create, plus annual maintenance of the plan.
- Complex

THE SUCCESSION PLAN

Communication

- Once you identify a successor and have a plan it should be communicated.
- Communication can alleviate fairness hard feelings.
- Be open to making adjustments.

QUESTIONS