Tax Efficient Capitalization and Business Success(ion)

Attracting, Winning and Retaining the High Net Worth Business Client

An Overview for Bankers

Michael A. Coffey

Lisa J. Tilley, CPA

CORPORATE CAPITAL RESOURCES LLC

What Role Will You Play In…

?

…The Greatest Wealth Transfer in U.S. History?

About $5,000,000,000,000 in the next decade
(But who's counting?)

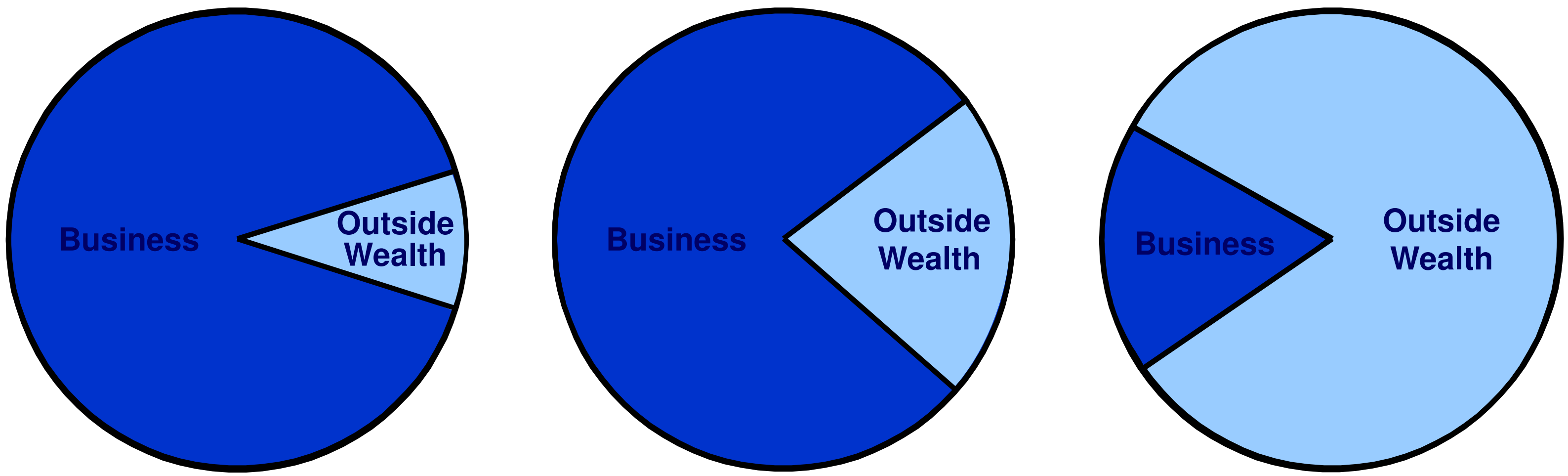
Looking at Private Shareholders in a New Way…

…And Seeing the Way Forward.

Private Business Succession

- At any given time, about 40% of closely-held U.S. businesses are facing a transfer of ownership.
- Less than 1/3 of closely-held family businesses survive the transition from first to second generation ownership.
- Plans are unclear – For CEOs who are:
  - Retiring in 5 years – 42% have no identified successor.
  - Age 60+/- 28% have no successor.
- In 25% of the cases, involving a closely-held business, the successor has no full-time work experience outside the company.

Percent of Their Net Worth



Age 40
Business Growing

Age 50
Business Successful

Age 65
Business Transition

Growth is Taxed

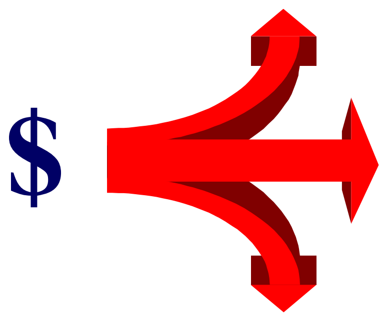
Transition is Taxed

And Death is Taxed

Your Closely-Held Clients and Prospects are Often Poorly Served When Facing an Ownership Transition

- **Most hope to cash out or transfer the business to family.**
- **In either case, your relationship to the client is at risk.**
- **Brokers and M&A specialists prey on your clients with promises – which can be kept (sometimes) – but which carry your client away.**
- **Your clients need unbiased strategic counsel to provide integrated options and an understandable process to achieve continuity goals.**
- **Their current advisors have grown older with them, but generally have little experience with sophisticated internal succession strategies.**

Implementing an Efficient and Effective Internal Succession Strategy Requires an Integrated, Multidisciplinary Approach



Rather than allow <u>divergent</u> plans to bleed after-tax dollars off in all directions from the corporation and the shareholders…

Implement <u>coordinated</u> strategies tailored to meet your needs.

We Are Talking About How You Can Be Instrumental in a Process to:

1. **Keep Your Client or Prospect Locally-Owned and a Client**
2. **Keep Control Where Desired**
3. **Create Remarkable Tax Savings for the Company and Owners**
4. **Participate in Larger and Better Loans, Money Management & Product Sales Generated Specifically by Our Process.**
5. **Become a Trusted, Strategic Advisor**

Forces Working Against Succession Planning

- For the Owner
  - Fear of Death/Disability
  - Reluctance to let go of Power and Control
  - Loss of Personal Identity
  - Absence of Outside Interests
  - No Source of Plan Funding

Issues in the Private Business

- Participation
  - Who can participate in the closely-held corporation and under what circumstances?
- Leadership and Ownership
  - How to prepare the next generation management to assume responsibility for the business?
- Letting Go
  - How the owner(s) can see their way clear to let go of the business (get some ‘skin out of the game’)?
- Attracting and Retaining Key Employees

Basic Reasons Why Owners Fail to Successfully Transfer Their Business

- Lack of viability of the business
- Reluctance on the owner’s part to give up control
- Reluctance of rising management to take the helm or family members to work in the company
- No real buyers
- Adverse tax consequences
- <u>Lack of planning</u>, which is a primary cause for failure

Options/Structures Available to Business Owners (An Alphabet Soup…)

- Close/Liquidate the Business
- Sell to an Outsider
- Sell to Family Members and/or Employees
- Gifts of Stock
- Family Limited Partnership
- Installment Sales to Family Members or Rising Management
- Retain Ownership but Hire Outside Management and Established Deferred Compensation Arrangement(s).
- Keep Taking a Paycheck, Retain Ownership & Management Control as Long as Possible…then Shutter the Shop.
- Charitable Trusts Benefiting Owners and Charity
- Gifts to Public Charity or Private Foundation
- Shareholder-Controlled Employee Stock Ownership Plan (ESOP)
- Life Insurance Funding of Buy-Sell Agreements
- A Combination of Some of the Above…

Common Sale Mechanisms

1. Sale of Assets to Outside Purchaser
2. Sale of Stock to Outside Purchaser
3. Sale of Stock to the Corporation
4. Sale of Stock to Family/Key Employees
5. Sale of Stock to Employee Stock Ownership Plan

PRIVATE CORPORATIONS

Some of the Taxes Impacting Companies, Their Owners and Families Over Time

- Corporate Income Taxes
- Personal Income Taxes
- Capital Gains Taxes
- Gift Taxes
- Estate Taxes
- Generation Skipping Taxes……

These are Seldom Addressed in an Integrated Fashion

PRIVATE CORPORATIONS

The Plain White Bread Deal: Selling to Management

- The rising manager, if capable, is still generally an honorary lifetime member of 'Shallow Pockets Anonymous.'
- "OK, we'll bonus her the money & she'll buy our stock."
- $100,000 bonus to a rising manager – manager pays $40,000 taxes, leaving $60,000 for stock purchase.
- Manager buys $60,000 of stock from shareholder: shareholder pays $10,000 capital gains tax (increase after 2008?)

Box Score: Government $50,000 - Owner $50,000

Sale of Assets to Outside Purchaser

1. The corporation sells all or part of its assets to a third party for cash
2. If substantially all the assets of the corporation are to be sold, a board resolution is required recommending sale and approval by stockholders
3. Purchaser may not be liable for debts and obligations of the corporation
4. The purchase price must be allocated among assets sold to determine gain or loss for the seller and the cost basis for the purchaser
5. Tax implications for corporation
6. Tax implications for stockholder

Sale of Stock to Outside Buyer (The Holy Grail)

- Complete Sale of Stock to an Outside Purchaser
- Partial Sale of Stock to Outside Purchaser
  - New purchaser generally will purchase enough to gain control
  - Minority stockholders have limited powers
- Tax Consequences of Sale
  - Long-term capital gain treatment vs. ordinary income

Sale of Stock to Corporation (Redemption)

1. Sale must not impair capital of the Corporation or cause it to become insolvent

2. Corporate redemption reduces the number of issued and outstanding shares (counter dilutive): may alter control and share valuation post transaction

3. Tax Consequences to the selling Stockholder

   – **May** qualify for capital gain treatment or may be treated as dividend.

4. Tax consequences to the Corporation

   – No taxable gain to the Corporation unless it uses appreciated property in redemption.

   – ***Stock acquired with after-tax dollars***

   – Interest on promissory note is generally tax-deductible.

Objectives for the Owners

- Provide a Tax Favored Mechanism for Owner to Extract Equity
- Establish the Most Tax Efficient Vehicles for Estate and Gift Tax Planning
- Provide Protection in Event of Death or Disability Prior to Ownership Transition
- Coordinate Most Efficient Vehicles to Achieve Goals
- World Peace (Well…Maybe Not)

Objectives of Succession Planning for the Company

- Provide for continuity of business through transition of ownership and management – keeping control where desired
- Provide certainty for employees and rising management
- Identify mechanisms for financing the ownership transition
- Provide incentives for key employees to remain before and after the transfer of ownership

IF CORPORATE CONTINUITY IS THE GOAL: CONSIDER A TAX SHELTERED SALE OF STOCK TO ESOP

- An ESOP is a qualified retirement plan under IRC Section 401(a) designed to invest primarily in company stock.
- Stock and/or cash contributions are tax-deductible to the sponsoring company.
- Contributions made to the ESOP can be used, by the Plan Trustees to purchase shares from the company, its owners and departing plan participants.

TAX SHELTERED SALE OF STOCK TO ESOP

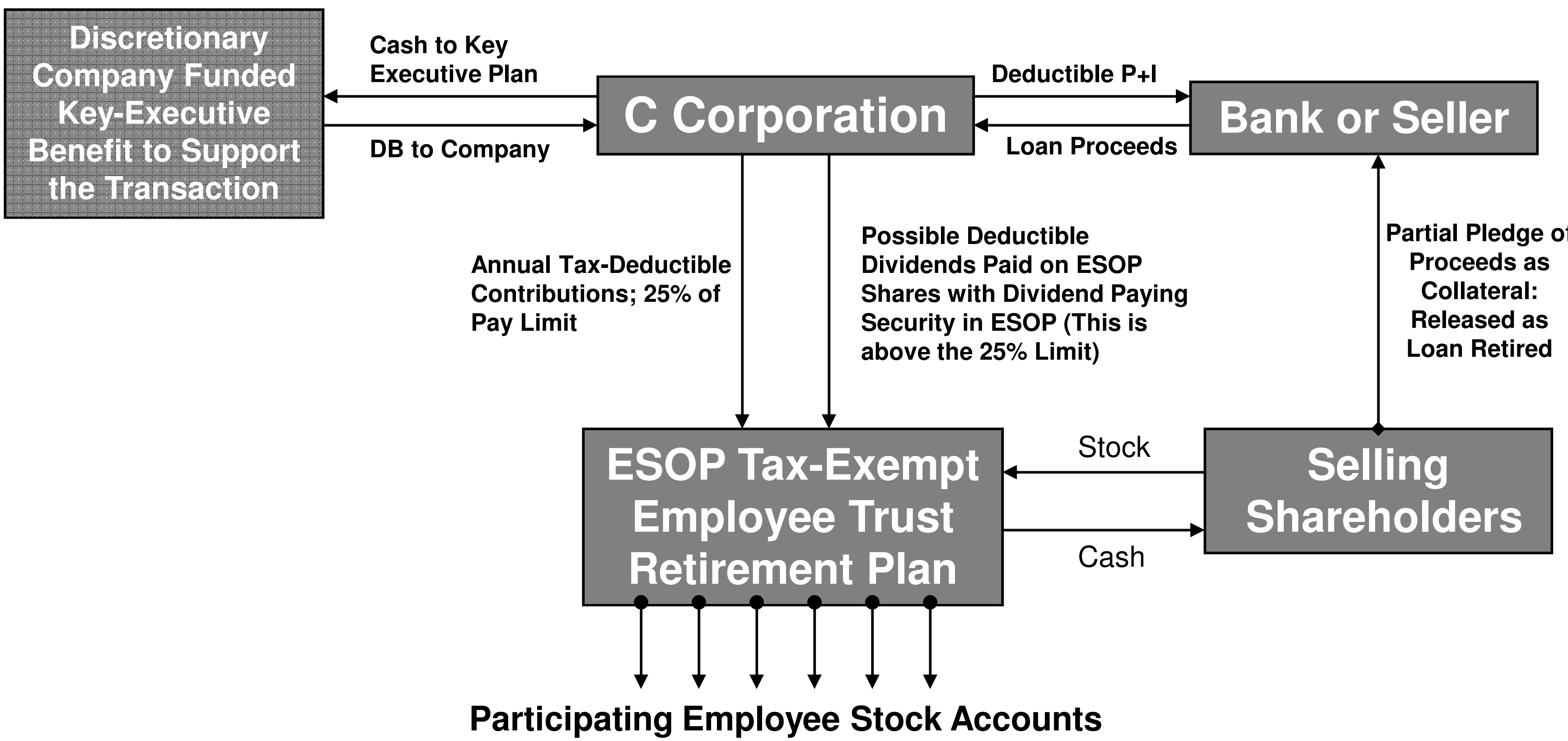
- Unlike other retirement plans, an ESOP can borrow money to buy stock. The loan repayments (including principal) become <u>fully</u> tax-deductible.

- An ESOP can "save-up" company contributions of pre-tax cash to make later stock purchases <u>without</u> the need for any loan.

- Stock held by the ESOP is controlled (voted) by the Trustee which may include owners, family members, key employees, or any combination.

Building Your Own Buyer

Simplified C Corporation Leveraged ESOP Stock Purchase



If ESOP reaches 30% or greater ownership, sellers may elect the 'tax-free rollover' on proceeds received within one year of sale

Myths About ESOPs

- You have to borrow money to make an ESOP work.
- They don't work in family businesses where the kids are to take over and don't work with management buyouts.
- Once you install an ESOP, you are handcuffed to the thing.
- You have to sell 30% of the company to get any benefit.
- You get in bed with your employees and lose control.

ALL OF THE ABOVE AND MANY OTHER THINGS YOU HEAR ARE NOT TRUE

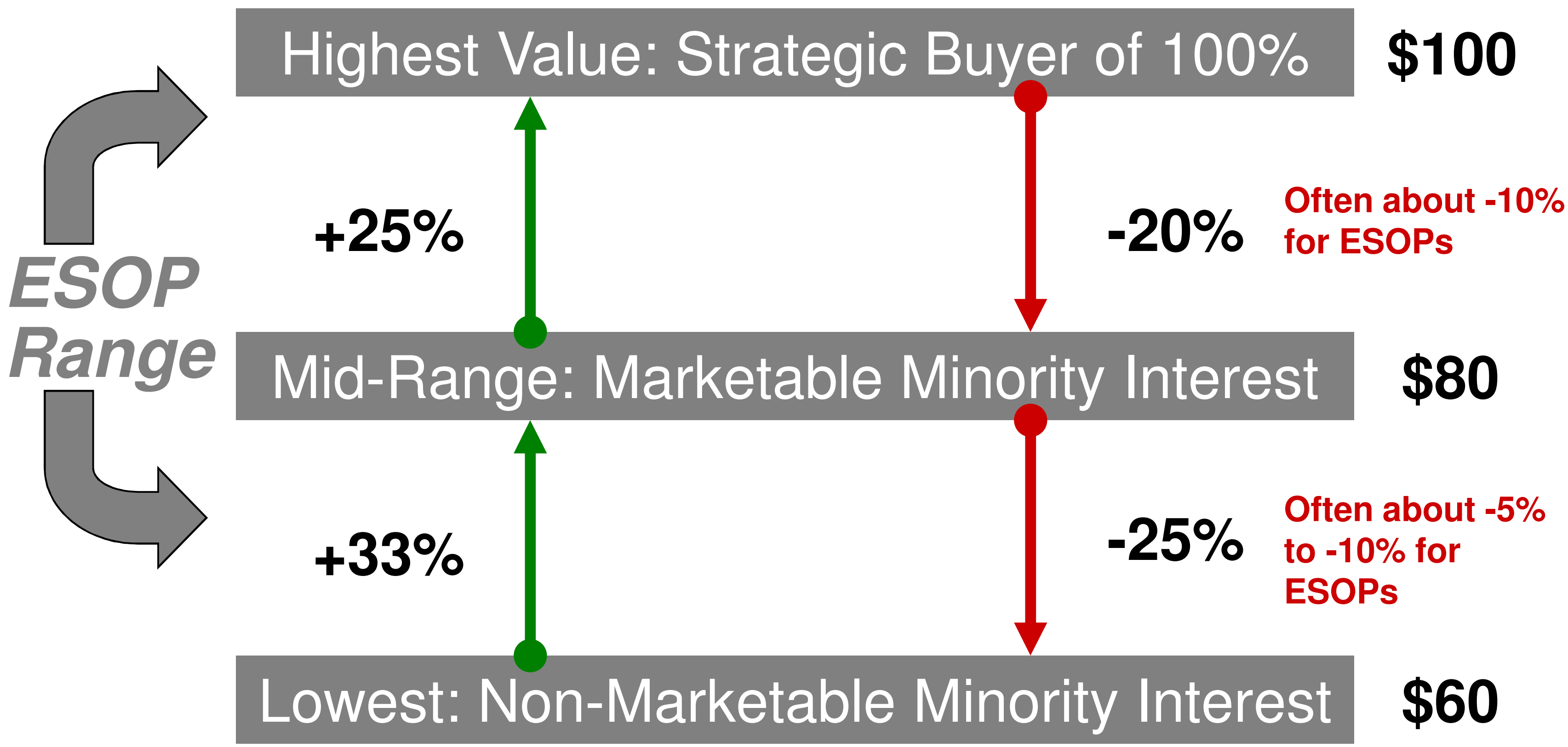
Corporate Capital Resources LLC

If I can sell to rising management, an ESOP or a third party…what's the business worth?

1. Basic rule: the business is worth what a real buyer would actually pay for it. (There are many deals proposed that never close & offers made that are not 'sanforized' – that is, they <u>shrink</u> in real cash terms as you approach closing)

2. What if there is no 'real' buyer? An appraiser can value the company assuming a 'willing buyer and willing seller' exist. There are many methodologies for this.

Private Stock Valuation
Three Basic Levels of Value



These percentages illustrate approximate ranges of independent valuations of closely-held corporation stock for family gifts, key executive stock plans, sales to an ESOP.

Corporate Capital Resources LLC

How to Coordinate the Valuation, Taxes, Family Wealth Preservation and Return on Equity for an Internal Business Succession Plan

When Planning Business Succession:

1. Take the time and money to get a solid, independent appraisal for the specific purpose in mind: Gift of stock, partnership interest gift to family, sale to ESOP.
2. ESOP valuations must be independent for the ESOP Trustee(s), meet DOL/IRS requirements and specify many things, i.e. minority or majority interest ESOP.
3. Remember that value is transaction dependent: A gift of a small limited partnership interest will have a significantly lower value than a majority sale to an ESOP, for example.
4. This means that you can create 'hybrid' integrated transactions which take advantage of tax savings plus valuation differentials.

Where Does the Money Come From?

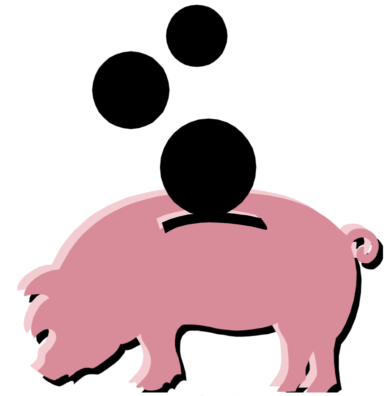
It's Your Company and Your Money:

- An ESOP company can borrow money to buy stock with tax-deductible principal and interest payments, and use untaxed dividends ("earnings") on ESOP shares to pay for stock.
- Current retirement plans can often be converted to an ESOP – example: a 401(k) can be converted to a 401(k) + ESOP ("KSOP") and the profit sharing match used to buy stock going forward.
- Most lenders are asset-based lenders and look for balance sheet or seller support of the deal.
- ESOPs not generally a take-the-money-and-run solution for majority shareholders.
- Where the combined cash-flow and balance-sheet based borrowing capacities are not sufficient to support the deal you want, there are still mechanisms available…

Stand Alone Senior Debt and Collateral

1. **For most successful closely-held corporations, the balance-sheet borrowing capacity is less than the cash-flow based borrowing capacity.**
2. **Typical maximum stand alone senior debt is the lesser of:**
   - Balance sheet and cash-flow borrowing capacity.
   - Limited by a multiple of cash flow to debt
3. **If there is a collateral shortfall from a lender's perspective, and the seller is unwilling to fully support the transaction, alternatives are:**
   - Mezzanine (subordinated) debt (expensive).
   - Limited personal guarantee (seller is first-out as the loan is retired).
   - Partial seller note at attractive interest rate.

The Tax-Free ESOP Cash Warehouse



If you have a little time, two, three or four years:

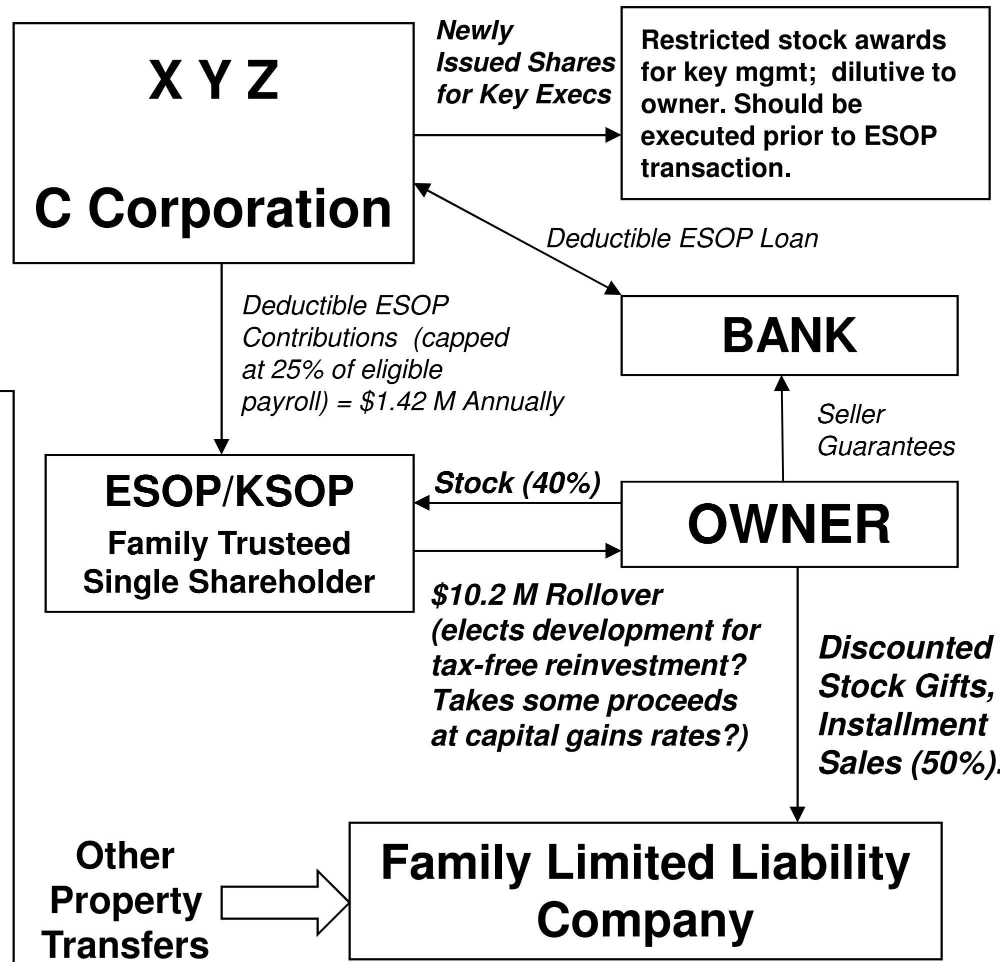
1. **Contribute corporately tax-deductible dollars to your ESOP.**
2. **Let the dollars compound tax-free net of trust attrition due to departing participants.**
3. **When time is right, sell shares...perhaps tax-free. The ESOP will buy from a shareholder, the company or a charitable trust holding the shares--at the fair market value.**
4. **The cash can be accumulated annually after meeting banking or other liquidity requirements – so when it comes out, no ESOP debt is needed for that amount of clean cash liquidity which goes to the seller as a lump sum.**

Dollars go in tax-free, grow tax-free, and sometimes…out tax free.

The Family Kept the Business, Cut Their Taxes 80% and Dad Got Tax Free Money

ESOP Valuation Assumption as Stock Market	
Full Enterprise Value:	$29 M
Minority Interest Discount (12%)	($3.5) M
Minority ESOP Value	$25.5 M
Sale of 40% to ESOP Yields:	$10.2 M

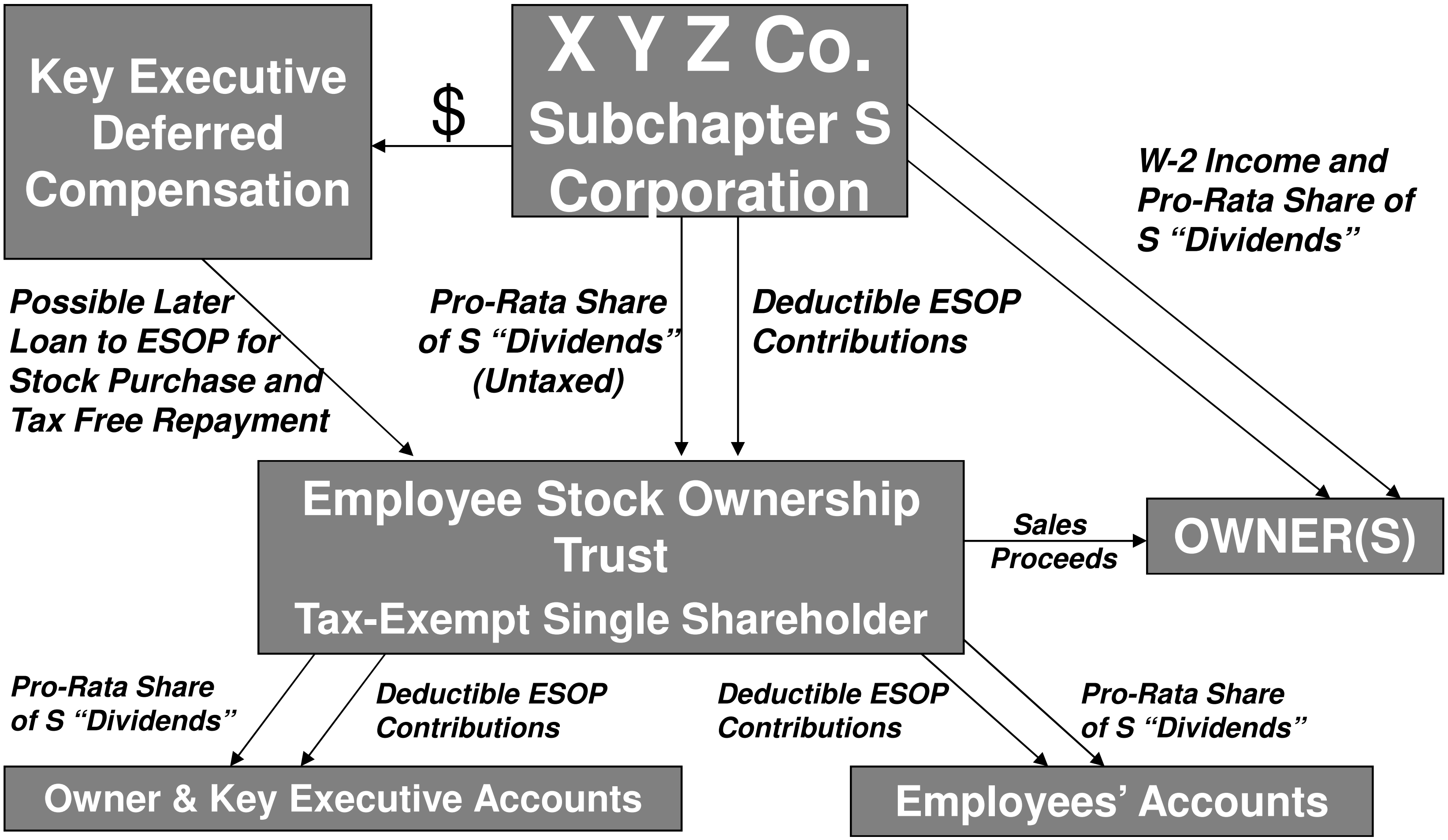
Post Transaction Gift/Sale Discounting	
Pre-ESOP Enterprise Value:	$29 M
Post-ESOP Enterprise Value:	$22 M
Owner Retains 10%	
Value of Remaining 50%:	$11 M
Minority Interest Discount (12%)	($1.3 M)
Lack of Marketability Discount (30%)	($3.3 M)
Discounted Gift Value Estimate	$5.4 M
Second Tier Family LLC Member Interest for a 50% Interest Gift	
LLC Discount (LOM/MI) (35%)	($1.9 M)
Value of LLC	$3.5 M
LLC Family Gift (43% of LLC)	= $1.5 M
Seller Note for 20 Yrs (57% of LLC)	= $2.0 M
(P+I = $154,178)	



Bank loan required for ESOP rollover transaction with tax-free reinvestment. Banking covenants will require full owner guarantees. Direct lineal descendants do not participate in the ESOP.

Key Executive Plan + Subchapter S ESOP

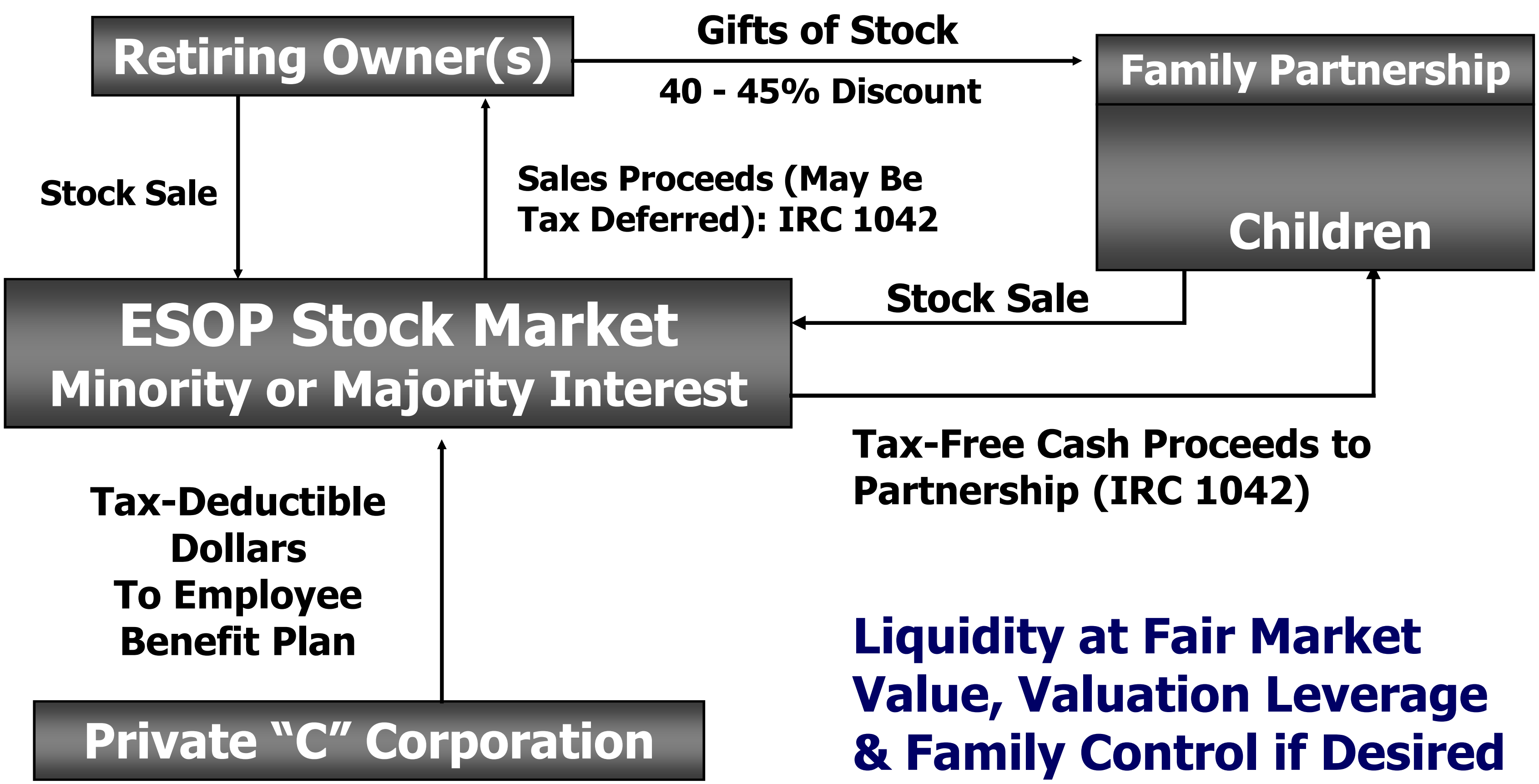
Tax Sheltered Stock Purchases + Build-Up of Key Executive Capital to Support Ownership Transition (Possible 100% Tax-Exempt Operation).



Note: The IRS counts key executive deferred compensation as a type of 'synthetic equity'. This is not typically an issue for properly designed plans with over 20 to 30 participants. For smaller plans, both the qualified (ESOP) plan and the non-qualified (deferred comp) plan will need future coordination to comply with this interpretation of EGTRRA 2001.

Corporate Capital Resources LLC

The Family Limited Partnership + Employee Stock Ownership Plan



Liquidity at Fair Market Value, Valuation Leverage & Family Control if Desired

Tax Exempt C Corporation CRT Strategy

- Family/Management Control
- Corporate Tax Deduction
- No Capital Gains Taxation
- No Estate Taxes on Stock
- Owner Diversification
- Owner Income Tax Deduction
- Zero or Minimal Gift Taxes
- Tax-exempt ILIT proceeds replace value of stock gifted to charity

Shareholder

$

ILIT

Stock

Cash Income
Tax Deductions

Charitable Trust

Stock

Cash

Company

Pre-Tax Cash

ESOP
Market for Shares
Retirement Plan

Vested Benefits

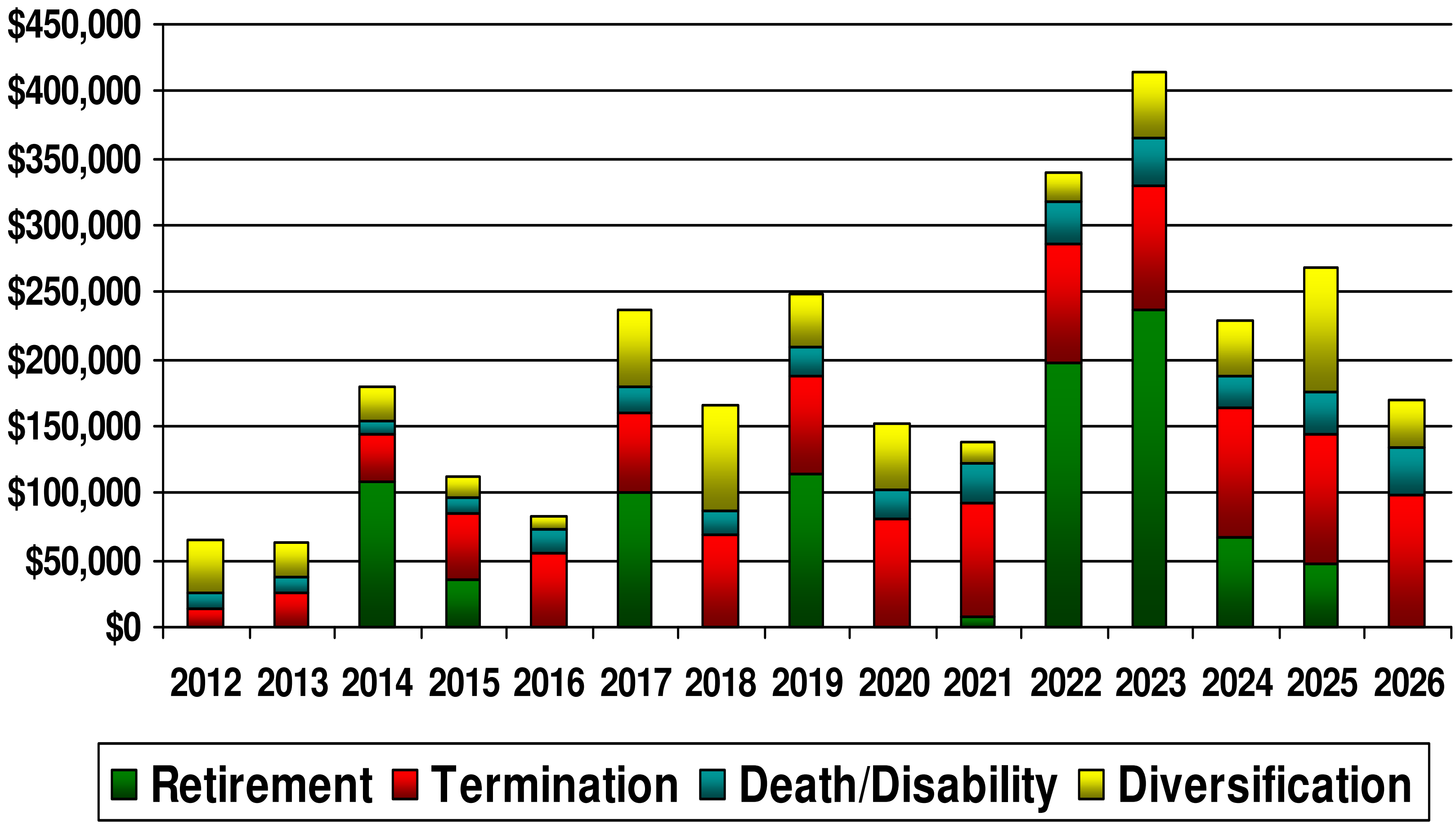
Family/ Management

Vested Benefits
(Cash, Not Stock)

Employees

Note: There are different rules for Sub S corporations

The ESOP Repurchase Obligation
A 'Next Generation' Issue



ESOP Participants Receive Cash (not Stock) for Their Vested Retirement Plan Payouts – Thus a Long-Term Emerging Stock Buyback Liability.

Note: This can and should be managed/funded in conjunction with key executive plans.

Succession Occurs in Four Phases

1. Initiation:	Owner Motivation
2. Education:	Understanding Taxation & Business Impact of Planning Options for All Parties
3. Selection:	Choice of Direction
4. Implementation:	Establish Time Table for Implementation & Execute Transaction(s)

Some (Hardly All) of the Essentials When Considering Business Succession

1. Work with independent, non-product-driven specialists who have genuinely ‘been there, done that’ and take a comprehensive approach in coordination with trusted advisors

2. Coordinate business continuity and capitalization with personal and corporate strategies:
   - Conversion of your equity to cash at the fair market value.
   - Key executive gain-sharing and deferred compensation.
   - Your family estate planning.
   - Rank-and-file compensation and benefit packages.
   - Need for rising management to assume your role and obligations.

3. Take care that business appraisals are independent and tailored to the transaction best for your client, the family and the company.

4. Be prepared to deal with complexity.

5. Remember, this is not just business success(ion) for the client – but business success(ion) for the bank.