

I Can't Quit – I Own It

By Richard A. Schlueter, President

At one time or another, most business owners think about life after their business. While some owners may be preparing for the transition to retirement, others may dream of moving on to the next stage of their career. And of course, there are always some diehards who have every intention of running their company for the rest of their lives. No matter what your plans are, the day will eventually come when you will no longer run your business.

Although some business owners consider what will happen to their business when they retire or leave, few move beyond thinking into planning. It is estimated that as few as 20 percent of all closely held businesses in the U.S. have a formal succession plan in place. Given this statistic, it is not surprising that only 35 percent of family businesses survive past the first generation of ownership, and only 20 percent survive into the third generation.

If you want your children or key employees to carry on with your business, you must have a formal succession plan to ensure that it happens according to your wishes.

There are several ways that a business can be transferred to the next generation of owners, including:

1. Gifting shares of your company to your children.
2. Transferring your business as part of your estate.
3. Selling to your management team.
4. Selling to an Employee Stock Ownership Plan.
5. Selling to an outside buyer.

This article briefly describes each of these alternatives.

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Gifts

Each year, each parent can give up to \$13,000 in assets to their children tax-free. This exemption is adjusted occasionally for inflation. Under this provision in the tax code, you can gradually transfer your company to your children by giving \$13,000 worth of your company's stock each year to each child. At that rate, it could take a considerable amount of time to transfer control of your company to your heirs.

The tax code also allows each taxpayer a "unified credit exemption" of up to \$1 million. Under the unified credit, a donor can give up to \$1 million tax-free over his lifetime. Gift tax is owed on any amount in excess of the unified credit. Under the Economic Growth and Tax Relief Act of 2001 (EGTRA), the top gift tax rate gradually declined from 49 percent in 2003 to 45 percent in 2009, and will be based on the top individual income tax rate in 2010.

While gifting may be the simplest way to transfer ownership of your company to your children, it has some disadvantages. Quite often, family dynamics can make prudent business decisions difficult. For example, gifting can pose problems if some children are less involved in the business than others. While it may be logical to give the business to those children who know it best, issues of fairness to the other children may arise. Under these circumstances, it may be best to sell the business to the active children, and then distribute the proceeds from the sale equally to your children via additional gifting or via your estate. If your company is an S Corporation, to the extent of the ESOP's ownership, there is generally no tax paid on the income allocated to the ESOP.

Estate Transfer

Unfortunately, estate transfers are the default succession mechanism for those business owners who have failed to plan. If you continue to postpone succession plans, then your business will ultimately be transferred after your death through your estate. Your estate may not be the most advantageous way to transfer your business to your successors because estate taxes can be onerous and because it could put

your family in a position of making difficult decisions at a time when they are under emotional stress.

In 2009, the top estate tax rate was 49 percent, which is much higher than business and personal tax rates. Under EGTRA, the estate tax rate was lowered gradually to reach 45 percent in 2009; then the estate tax will be repealed in 2010. However, this repeal may only be temporary. If Congress does not vote to continue the repeal, the top estate tax rate will return to the rate from 2001 which could result in a tax rate of up to 55 percent for persons with large estates.

As in gifting, the tax code allows a unified credit exemption for estate taxes. In 2003, the first \$1 million of your estate was not subject to estate tax. Under EGTRA, the unified credit rises to \$1.5 million in 2004 and 2005, \$2 million in 2006 through 2008, and \$3.5 million in 2009. Again, if EGTRA is not continued, the unified credit will revert to \$1 million in 2011.

Assuming the very likely scenario that estate taxes are not repealed, the estate tax bill could place a significant burden on your successors. If you intend to transfer your business through your estate, you should give some thought to providing some sort of funding to cover estate taxes so that the business does not have to take on additional debt just to pay estate taxes.

A Management Buyout

In a leveraged buyout (LBO), key employees and/or family members buy out your interest in the business. LBOs offer a lot of flexibility. LBOs can be arranged with a combination of internal and external financing, deferred compensation, and consideration for non-compete agreements. The structure of the deal depends on a variety of factors including the value of the company, the ability of the company to take on additional debt, the lenders' requirements, and your own requirements. Because these transactions can be complicated and involve a number of parties, it can be beneficial to use a consultant to pull it all together.



Transfer to an ESOP

An ESOP can provide an advantageous way to transfer ownership of your company to your employees, who may be the most logical people to carry on the business. This approach also serves as a way to reward employees for helping to build your business.

There may be certain tax advantages for transferring ownership to an ESOP. Under certain circumstances, you may be eligible for certain tax advantages when selling stock in a regular C corporation to an ESOP. If certain other requirements are met and if you invest the proceeds of the sale in qualified replacement securities, you can defer taxes on the gain from the sale of your stock in your company. By investing the proceeds in replacement securities, you achieve a more diversified portfolio to help ensure security in retirement.

There also may be tax advantages for the company. Under certain circumstances, C corporations can effectively deduct the cost of both the principal and interest on an ESOP loan because they are considered contributions to the ESOP plan.

Sell to a Third Party

There are several reasons why it may not be feasible or reasonable to transfer your business to your family or your employees. If this is the case, the best exit strategy may be to sell the business to a third party. Chances are, there is a competitor or a supplier who may be interested in acquiring your company.

Once you decide to sell your business, you will be faced with a number of difficult questions, such as: what is a fair price for my company; will the interested buyer be able to arrange financing; will the sale be structured as an asset sale or a stock sale; will I still be involved in the business or will I have to sign a non-compete agreement; what are the tax consequences of the sale? It may be difficult to answer some of these questions objectively since your business represents years of your sweat and blood.

Because of your understandable emotional connection to your company and the complexity of most business transactions, it is wise to involve an expert in the process. A financial advisor can help you navigate the complexities of a sale transaction to your best advantage.

Conclusion

This article is a brief overview of options to consider when you develop a succession plan. The best option for you depends on your needs and the specific situation surrounding your company. No matter which route you chose to take, it is imperative that you take the time to develop a sound succession plan designed to meet your needs and ensure the survival of your company.

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About the Author

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Rick is a Senior Member of the American Society of Appraisers and is a cofounder of ComStock Advisors. He has over 20 years of experience in the valuation and management of closely held business interests, as well as securities comprising their capital structure. He has extensive background in trust and estate planning, Employee Stock Ownership Plans (ESOPs), litigation support, and related financial advisory service. He has acted as an arbitrator and has served as an Expert Witness and Consulting Expert regarding financial issues in the United States Federal Tax Court and the United States District Court.