

Business Succession

The No-Tax Solution

Management Succession
Ownership Transfers
Estate Planning
May, 2011

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Business Succession Objectives:

- Develop Successor Management
- Transfer Ownership Interests
- Achieve Financial Goals

Management Succession:

- Corporate Governance
 - Shareholder functions
 - Elect Directors
 - Capitalization
 - Board functions
 - Set policies/ objectives / business plan
 - Appoint officers / oversight
 - Officer functions
 - Implement business plan
 - Operate the Company

Management Succession (cont...)

- Recruitment and Development of Management
 - Family v. business priorities
 - The management life cycle
 - Incremental accession
- Professionalization of Management
 - Independent outside directors
 - Limits on self dealing by corporate fiduciaries
 - Audit committee
 - Corporate formalities

Management Succession (cont...)

- Sarbanes-Oxley Act of 2002
 - Independent Audit Committee
 - Restriction on Loans to Officers and Directors
 - Certification of Financials by CEO and CFO
 - Assessment of Financial Controls
 - Code of Ethics
- Tittle v. Enron
 - ERISA Fiduciaries
 - Corporate Fiduciaries
 - Procedural Prudence

Ownership Transfers:

- Internal Ownership Transfers
 - Cross purchase agreements
 - Stock redemption agreements
 - Trust, gift or bequest
 - Family limited entities
 - Life insurance funding
- External Ownership Transfers
 - Stock or asset sale to outside party
 - IPO (rare option for closely-held)
- Employee Stock Ownership Plans

Ownership Transfers:

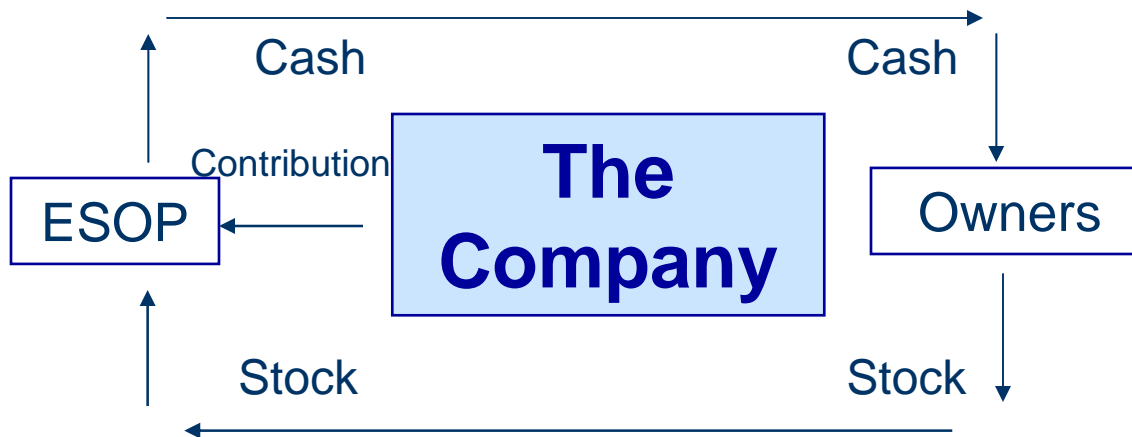
Business Valuation Methods

- USPAP and Fair Market Value
- Income (Intrinsic)
 - Capitalized income
 - Discounted cash flow
- Market Guideline
 - Transactions
 - Ratios from traded companies
- Net Asset
 - Liquidation basis
 - Not on-going business

Ownership Transfers – (cont...)

Employee Stock Ownership Plans

Non-Leveraged

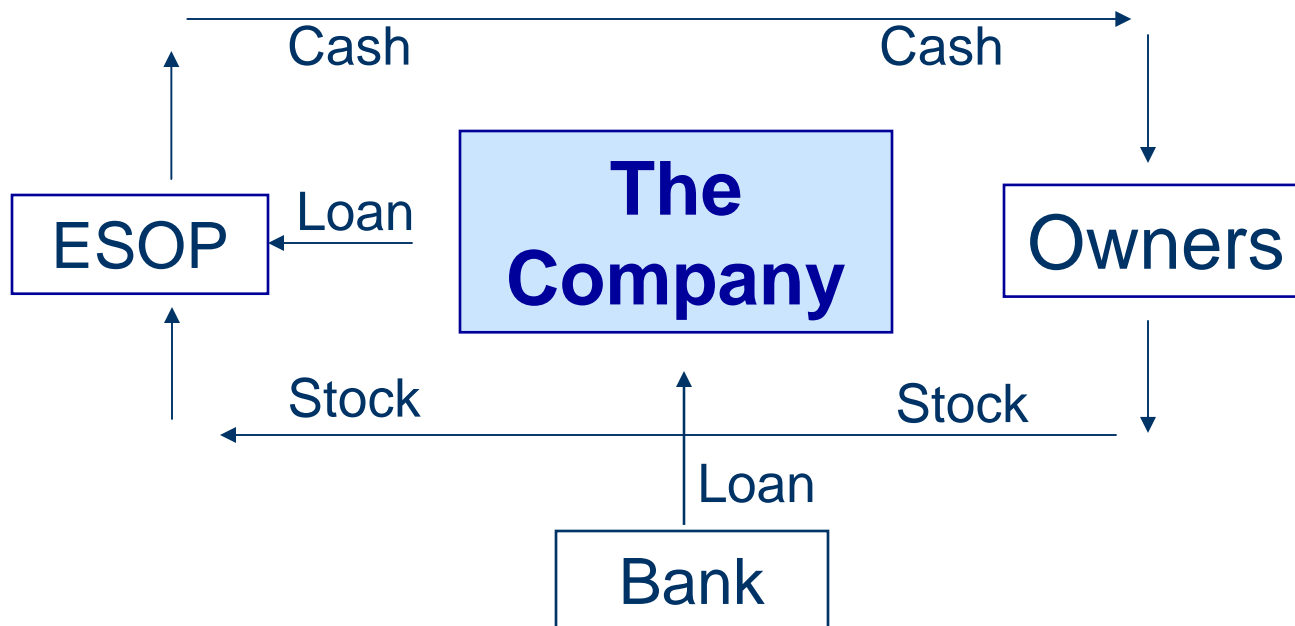


- Contributions Limited to 25% of Eligible Compensation
- Contributions Deductible
- May 'Pre-fund'
- Convert Existing Profit-Sharing Plan/Purchase Stock

Ownership Transfers (cont...)

Employee Stock Ownership Plans

Leveraged



- Loan Principal Deduction up to 25% of Eligible Comp
- Additional 25% Deduction for additional DC plan
- C Corp – Unlimited Interest Deduction
- S Corp – Interest Included in 25%

Ownership Transfers (cont...)

Employee Stock Ownership Plans

- IRC § 1042 Deferral of Gain (C corp)
 - 30% Requirement
 - Three Year Holding Period
 - No Allocation of 'tainted shares' for 10 years from sale
 - 25% shareholders
 - Sellers electing §1042 treatment
 - Family members of selling shareholders
 - Becomes exempt upon gift of QRP or death of taxpayer (step up basis)

Ownership Transfers (cont...)

Employee Stock Ownership Plans

- Qualified Replacement Property (QRP)
 - Domestic operating companies
 - Replacement period – 3 months prior/12 months after sale
 - Monetize or leverage QRP
- Election Procedure
 - Attach Consent, Election and Purchase to Form 1040
 - Irrevocable upon perfection

S Corps and ESOPs

- **Subchapter S election:**
 - Corporate income/loss passed through pro rata to shareholders
 - Shareholders can receive cash distributions without additional tax
 - Corporation may retain such income for other purposes
- **The Small Business Job Protection Act 1996**
 - Authorized qualified plan trusts, including ESOPs, to own S Corps
- **Taxpayer Relief Act of 1997**
 - Removed tax on Sub S earnings applicable to other qualified plan trusts
 - Eliminated right to elect stock distribution

S Corp ESOP Features

- No corporate income tax
- No income tax to ESOP
- No deduction for profit distributions
- Profit distributions cannot pass to participants
- Loan repayment only for distributions on unallocated stock (and allocated under AJCA of 2004)
- Loan interest included in 25% contribution limit
- Allocation restrictions under Code Section 409(p)
- No tax-free or tax deferred rollover upon stock sale to ESOP

Ownership Transfers (cont...)

Family Limited Entities (FLEs)

- Family Limited Partnership (FLP)
- Family Limited Liability Company (FLC)
- Advantages:
 - Shield assets from creditors
 - Gift discounted interests
 - Harder for donees to spend gifted interests
 - Provide centralized asset management
 - More flexible than irrevocable trusts
 - GP can be revocable trust

Ownership Transfers (cont...)

Family Limited Entities (cont...)

- Issues and Concerns:
 - State minimum franchise tax if LLC taxed as C corp
 - Administrative Issues (tax returns, etc.)
 - State laws mandating reassessment of value on transferred property
 - General partner liability (use LLC or corporate GP)
 - Death or term of GP terminates LLP
 - LPs get Form K-1 even if no distribution

Ownership Transfers (cont...)

Family Limited Entities (cont...)

- IRS Considerations
 - Lack of marketability & control discounts
 - Business purpose doctrine
 - § 2036 issues (retained life estate)
 - Thompson, Strangi and Kimball*
 - ignoring FLP formalities
 - transfer of personal assets
 - result: FLP assets in estate
- Ohio: Creditors may get more than distributions

Ownership Transfers (cont...)

Family Limited Entities (cont...)

- Family Limited Liability Company (FLC)
 - Similar to FLP
 - Operation and treatment less certain (new entity)
 - Less case law for guidance
 - All members of LLC have limited liability (vs. only LPs in FLP)
 - LLC members participate in LLC management (unless management separate from members)
- Funding: Lump sum or incremental

Financial Planning

- Charitable Remainder Trusts (CRT)
 - Annuity trust
fixed dollar payments (at least 5% of assets)
no additions to corpus
 - Unitrust
at least 5% of assets or, if less, trust income
additions permitted to corpus
- Tax deduction based on FMV – PV of payments
5 yr excess carry forward (30% or 50% of AGI)
- Term life expectancy or 20 years max

Financial Planning (cont...)

- Irrevocable Life Insurance Trusts (ILIT)
 - Any Incidents of policy ownership?
 - Power to:
 - Change beneficiary
 - Borrow against policy
 - Transfer policy
 - If yes, then proceeds included in estate

Financial Planning (cont...)

Irrevocable Life Insurance Trust

- Additional considerations
 - Flexible Terms
 - Insurance proceeds to trust
 - Potential to estate by lending/purchasing assets
 - Transfer existing policy – 3 years prior to death
 - Trust purchases new policy – no 3 year rule

Financial Planning (cont...)

Irrevocable Life Insurance Trust (cont...)

- Gift Tax Issues:
 - Contributions to ILIT for premiums are gifts
 - \$13,000 single and \$26,000 if married
 - Transferring existing policy is gift. Gift tax return?
 - Lifetime limit of \$5 mil currently (\$10 mil if married)
 - Lifetime limit back to \$1 mil in 2013
 - Maximum rate 35% for 2010-2012

Estate Tax Schedule

<u>Year of Death</u>	<u>Exemption Amount</u>	<u>Maximum Rate</u>
2004	\$1,500,000	48%
2005	\$1,500,000	47%
2006	\$2,000,000	46%
2007	\$2,000,000	45%
2008	\$2,000,000	45%
2009	\$3,500,000	45%
2010	Repealed	0%
2011	\$5,000,000	35%
2012	\$5,000,000	35%
2013	\$1,000,000	55%

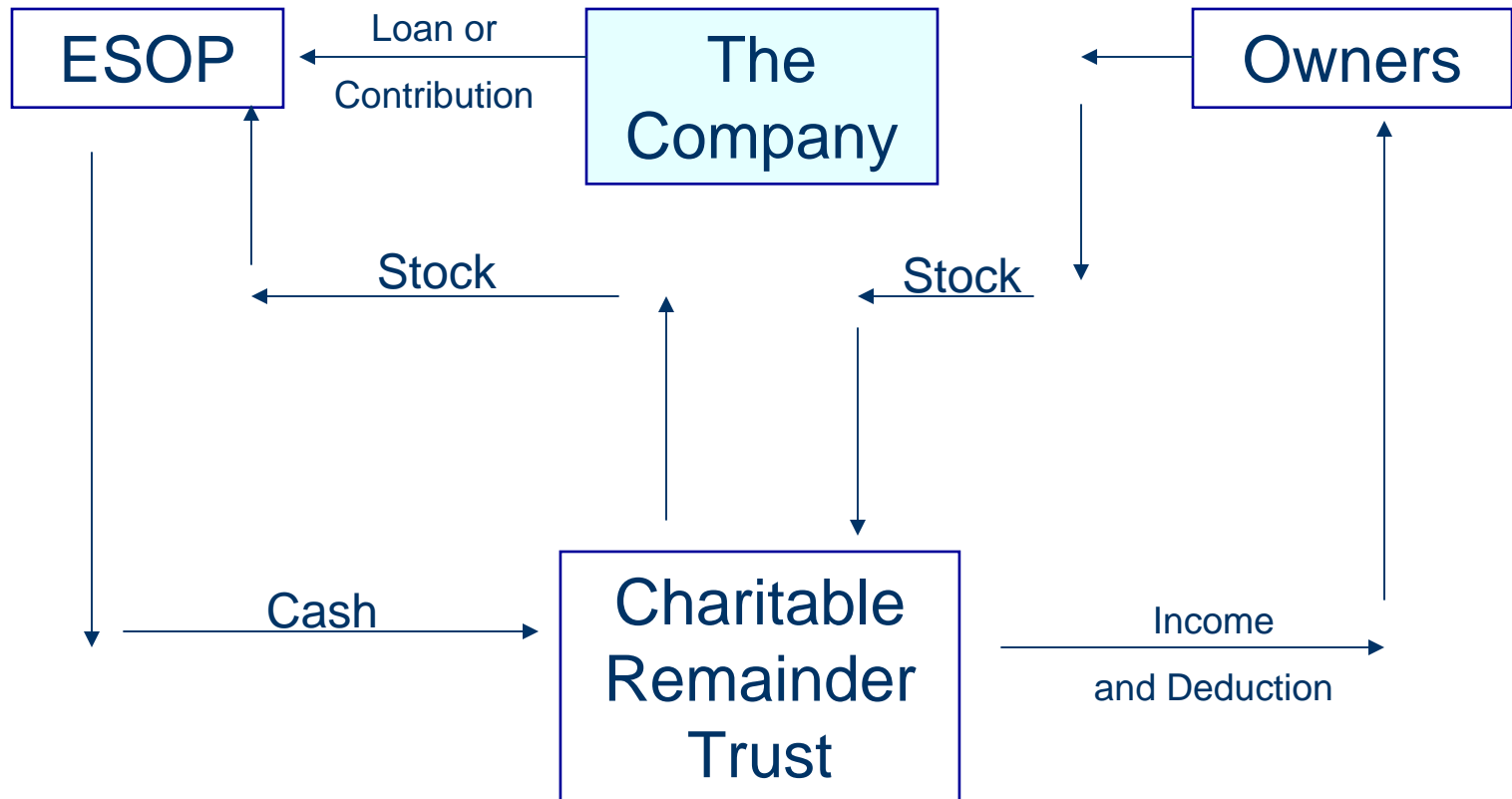
(double for married couple)

Financial Planning (cont...)

- A/B Trusts
 - Fully utilize exemption or credit for children (B trust)
 - Can name different beneficiaries for respective trusts
 - Unlimited residual to spouse (A trust)
 - Surviving spouse receives income; may invade corpus
- Possible Drawbacks:
 - Property use restrictions
 - Young “trophy spouse” outlives children
 - Legal / accounting expense
 - Family conflicts
 - Over funding of B trust during 2010

Advanced Techniques

CHESOP - Combination ESOP and CRT

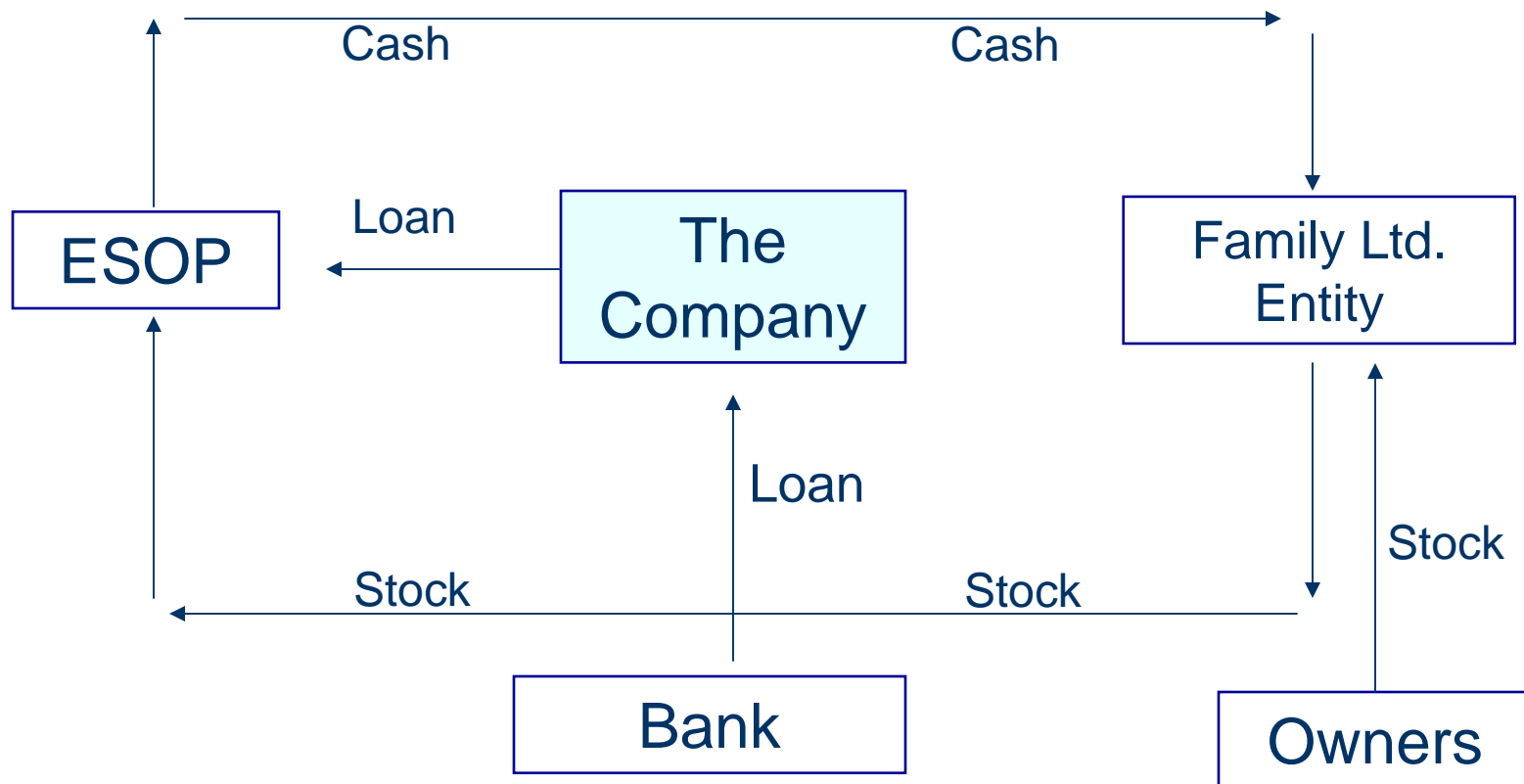


Advanced Techniques (cont...)

- Owners Deduct Net Present Value of Stock Contributed
- Deduction Over 1-6 Years
- Avoid Gains Without 1042 Transaction
- Stock in ESOP Allocable to Family Members / 25% Shareholders (unlike 1042 Transaction)
- Owners Generate Income from CRT

Advanced Techniques (cont...)

FLESOP – Combination ESOP and Family Limited Entity



Advanced Techniques (cont...)

- Family Limited Partnership (FLP)
 - Form Limited Partnership with LLC/corp General Partner
 - Transfer Company Stock to FLP
 - Gift non-control discounted FLP interests to children
 - FLP sells to ESOP at control price if LP has 50%+
 - FLP elects S.1042 and acquires QRP
 - FLP Interests have some protection from creditors

Caution: Transfer of QRP by LP results in gain recognition on QRP

Advanced Techniques (cont...)

- Family Limited Liability Company (FLC)
 - Similar to FLP
 - Use LLC instead of LP for § 1042 transaction? No direct authority.
 - Convert partnership to LLC? Yes: PLR 2002-243001

Conclusion:

Successful Succession Plans Consider

- Management Succession
- Ownership Transfer Methods
- Tax Implications (Income & Estate; Federal, State, Local)
- Financial Security of Owners
- Other Interests of Owners

Tim Jochim

- Tim Jochim, Chair, Business Succession/ESOP Group, Kegler, Brown, Hill & Ritter
- National authority on employee stock ownership plans (ESOPs) and business succession. Expertise in corporate finance, merger/acquisition and employee benefits.
- Adjunct professor of corporate finance at the Capital University School of Law, Columbus, Ohio.
- Member of corporate boards and frequent speaker to business and trade organizations.
- Author of *Employee Stock Ownership and Related Plans* (Greenwood Press, 1982), and of articles published in *The Journal of Employee Ownership Law and Finance* (Fall, 1998), *Taxation for Accountants* (July, 1998) and *Taxation for Lawyers* (September-October, 1998) and *Financier Worldwide* (February, 2011).
- Co-founder of the Ohio Chapter of The ESOP Association and a member of the legislative committee of The ESOP Association.
- Recognized as an expert attorney on ERISA and ESOP law and its application to closely held businesses by Chambers USA. Martindale-Hubbell Rating of AV.

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