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Business Exit Planning for Closely Held Businesses

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Just what is business succession planning? Business succession planning is the process of preparing to transfer control of a business to another person or business entity. The main objective of most business owners is to transfer the business to a third party in a way that minimally disrupts business operations and that maintains or even provides for enhanced valuation of the business for the owner transferring the business.

Why Have a Succession Plan?

There are a few key reasons for doing exit planning. The first of which is to provide liquidity for the owners of the business. Another important reason for doing exit planning is the minimization of transfer taxes whether by gift or by bequest in a will or trust. Many business owners want to provide continuity for the business as well so that the employees that have depended upon their jobs for so many years will not be left jobless. Last but not least, doing proper succession planning can help a business owner plan fairly for his or her children and other family members down the road.

For some business owners, the business does not represent the bulk of their assets. In such cases, transferring their business to the next generation may be preferred. But for most business owners, their main asset is their business. Therefore, making sure the value of the business is maximized and being able to liquidate and generate cash flow to fund retirement is an important reason to establish a succession plan.

Planning for Estate Taxes

However, if the business owner's objective is to transfer ownership to family members, a systematic plan of gifts and/or sale of stock in the family business from the owners to the successors over a period of years will benefit both generations. If no plan is in place and there is an unexpected death or disability of the owner, the value of the business and the ability of successors to continue on successfully in the business may be drastically diminished.

A business that has a high value (i.e., valued over $5,250,000 for unmarried business owners and over $10,500,000 for married owners) may also be subject to the estate tax. A client whose estate consists primarily of a family-owned business may want to retain the value and viability of the business to pass to the next generation but not be in danger of having to fire sale the business in order to pay the estate tax. This concern is legitimate because without proper planning, federal estate taxes, which in 2013 have a rate of 40 percent for taxable estates in excess of $5,250,000 for single taxpayers ($10,500,000 for married couples who jointly own their assets) can create a substantial tax liability for the heirs of a business. As a result, the inheritors of the business may find it difficult to pay the estate tax during a difficult transition period when their energies are needed to run the business. The best course of action is to have a succession plan in place that has already accounted for this contingency and that gives the heirs to the business the freedom to

continue on and maintain the value of the business without having to fire sale the business. The use of life insurance and life insurance trusts can help provide liquidity for the business owner's estate to avoid a forced fire sale of the business to pay the estate tax.

Another concern for business owners who wish to transfer their family business to family members is the generation-skipping transfer tax to family members more than one generation removed (i.e., grandchildren). This is a tax in addition to the estate tax in certain circumstances.

Most Common Ways an Owner Exits the Business

There are several ways that a business owner can exit his or her business. The most obvious is to sell the business to a third party or to create an ESOP. Another common business exit strategy is to transfer the business by way of gift, sale or GRAT to family members such as children. Yet another way to exit is to simply wind down the business and close up shop. Let's examine these options more closely.

Selling the Business

First, let's examine the various ways that business owners might sell their business to a third party. The first and most obvious is to list the business for sale either directly or through a business broker. There are many, many ways to structure a deal. The purchaser may want to continue on in the name of the corporation or LLC that was originally created and therefore would buy the stock in the corporation or membership interests in the LLC. Another common way is to sell the assets of the business only (referred to as an "asset sale"). This could include things like a customer list, software, equipment, trade-secrets, the trade name of the business, its web site or other digital assets, the building the business is operating out of, etc. The sale of the business can be set up for a one lump sum payment, but it is much more common to see structured buyouts that occur over time and even include annuities. Some business owners even structure the ability to stay on as a consultant for a number of years and are paid a salary regardless of how involved they are in the business.

If you have a business partner, it is strongly recommended that you set up a Buy-Sell Agreement so that there is no confusion as to ownership interests and so that heirs are not forced into the court process to gain access to their inherited interest in the business. It is not uncommon for two or more business partners to have a Buy-Sell Agreement funded with life insurance and plan for the proceeds to be paid to a business owner's spouse or the business owner's revocable trust. The latter is more powerful in that it provides better for unforeseen circumstances such as contingent heirs to the business.

Transferring the Business to Employees Through an ESOP

It is also possible for a business owner to set up what is known as an ESOP (Employee Stock Ownership Plan). An ESOP is a plan in which the company's capital stock is transferred to the employees of the company. Technically, an ESOP is a tax qualified defined contribution benefit plan. Functionally an ESOP is a very flexible tool that uses corporate tax-deductible money to achieve objectives like providing liquidity for shareholders, continuation of the business, raising working capital for the business, and charitable giving. An ESOP is unlike any other employee benefit plan in that the ESOP Trust, or ESOT, is designed to hold primarily stock of the sponsoring employer. A simple example is where the company creates a trust where the company contributes stock or cash to purchase stock. The

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stock is then allocated to individual accounts for the employees within the trust. When cash is contributed to the trust, it is used to purchase stock from the original shareholders. It is then allocated to the individual accounts of the employees.

Sales and Gifts to Family Members

One simple way to transfer a business to family members such as children is to use an intra-family loan. A benefit of using this strategy is that under Internal Revenue Code §7872, the minimum interest rates that must be used between a lender and a borrower is set fairly low (usually well below the prevailing market rate charged by banks). This code section also sets out the income and gift tax results if the loan uses an interest rate below the required minimum IRS rate of interest.

Another technique is to use an Installment Note sale to an Intentionally Defective Grantor Trust (aka IDGT) or to make annual gifts to an IDGT. These techniques can help improve the tax efficiency of the transfer and can enhance the seller's control in the transaction. These could be the most powerful tools available for giving more control while eliminating, shifting, or deferring taxes when doing a succession plan.

Basically, the sale transaction revolves around an asset installment sale to an Intentionally Defective "Grantor" Trust in exchange for a promissory note. The reason it is intentionally defective is not because there is anything wrong with the trust. It is simply to allow for the Grantor to pay the income taxes on the assets owned by the trust (allowing for a further estate "burn" of a larger estate).

Another planning tool is the SCIN (a Self Cancelling Installment Note). In general, a SCIN is used to sell an asset (typically shares, interests, assets in a family business, or an interest in real estate). It has been referred to as a cross between a private annuity and an installment sale, with many of the advantages of both.

SCINs are used primarily to sell an asset to either a trust or directly from an older family member to a younger family member. The seller sells the asset in exchange for an installment note with a term shorter than the seller's life expectancy. The IRS provides tables for the calculation of the life expectancy. The installment note contains a provision by which the remaining balance is completely canceled upon the seller's death. This type of arrangement works best for sales to a third party or to family members.

Grantor Retained Annuity Trusts (GRATs)

A Grantor Retained Annuity Trust (aka GRAT) may be a good option for owners who are expected to live for at least several years, want to keep most or all of the income from their business, and where the business is anticipated to go up in value over time.

In this type of arrangement, the owner retains an interest in the business before it is passed to the beneficiaries of the trust. This also allows for the transfer to be kept private and can protect the business against creditor claims.

To explain in basic terms how a GRAT works, first let's examine the mechanics of the trust. The business owner sets up the GRAT and then makes a gift of company stock to the trust. This type of trust is irrevocable and therefore cannot be changed or revoked. The trustee of the trust manages the company stock and any other assets transferred to the trust. The trust is drafted with provisions for an annuity to be paid from the trust to the business owner for a certain number of years. This is called the retention period. The annuity can be a fixed dollar amount or it can be drafted as a percentage of

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the value of the assets that were initially contributed to the trust.

If in any given year there is not enough income in the trust to pay the business owner the specified annuity amount, then trust principal must be used to make the payment. At the end of the retention period, the assets of the trust, including all of the appreciation in the assets, then go to the beneficiaries of the trust.

When the stock of the business is initially transferred to the GRAT, the IRS classifies that action as a gift to the trust beneficiaries. The gift however is reduced by the actuarial value of the annuity that the business owner retains an interest in. That amount is determined by several factors like the monthly interest rate set by the IRS, the age of the business owner, the number of years he or she will receive an annuity, and whether or not the trust beneficiaries are family members of the business owner.

Here is the interesting part. If the business owner lives until the end of the annuity term set forth in the GRAT, none of the assets that were transferred to the trust will be subject to the federal estate tax upon the death of the business owner.

Closing Up Shop

Lastly, a business owner can simply close up shop, cease all further business transactions and sell any assets of the business. If a business owner decides to do this, there are a few key issues that need to be addressed. If the business uses a web site, the owner should terminate the site or create a message on the web page that the business no longer exists.

Winding down a corporation or an LLC will also require some filings with the California Secretary of State. You will also need to notify the State Franchise Tax Board of the dissolution so that you no longer continue to pay the State Franchise Tax Board fee for the pleasure of doing business as an LLC or corporation in the state. You will want to cancel your business license and pay all existing obligations of the company. If you are filing to dissolve your corporation or LLC, the Secretary of State will want to ensure that you have met all of your legal financial obligations before they approve the dissolution.

If you operate out of an office, you will want to forward all mail for the business to a P.O. Box for at least 6-12 months or to your personal residence.

About the Author:
Brenda is an Estate and Business Planning Attorney with her primary office located in Carlsbad, California. Brenda graduated from the University of San Diego School of Law where she served as an Editor on the San Diego International Law Journal and published a journal article in the San Diego International Law Journal. She enjoys writing and has written a book on estate planning titled Safeguarding the Nest, Third Edition and co-authored a book on Elder Law titled, How to Avoid the Catastrophic Costs and Effects of Long Term Care, a California Elder Law Guide (released in April 2013). Her passion is helping families protect their children and their parents and helping business owners preserve and protect their businesses. On a more personal note, Brenda is married to Len, the CEO of a San Diego based company, and they have two children, Lenny (7) and Taylor (5), and two German Shepherds, Starsky and Semper. For more information or media requests, please visit www.GeigerLawOffice.net or contact Lexi Davis at (760) 448-2220.

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