The EXIT Planner

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WHAT'S INSIDE

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PARENTING FOR BUSINESS OWNERS 101

Do you suspect that your business may be worth more than you ever imagined? Have the sale prices of businesses like yours stunned you and prompted some curiosity about the value of your own business? If so, you aren't alone. Many business owners are discovering that the current red-hot M&A market has pushed the value of their biggest asset—their businesses—to heights they never imagined.

An enviable discovery to be sure but one that does raise a number of unforeseen issues. When business owners discover that the sale of their businesses will yield financial independence—and more—they logically begin to wonder how to transfer the wealth they don't need to their children.

Business owners struggling with the issue of passing wealth to children would do well to revisit their original exit objectives, namely, "How much money do you wish to have after the sale of the business?" Using that piece of information as a starting point, owners then move to the issue of "How much wealth should the children have? How much is too much?" Once those questions are answered, the business owner can then design a transfer mechanism that will pass the wealth to the children with minimum tax impact.

These, then, are the three subjects of this issue of **The Exit Planner**.

1. Fixing the owner's financial objectives before considering a wealth transfer.
2. Determining the amount of wealth to be transferred (and determining how much is too much),
3. Designing a wealth transfer strategy that keeps the IRS from becoming the largest beneficiary of your hard-earned cash.

ALSO IN THIS ISSUE

Again in this issue of **The Exit Planner**, we include a short article regarding a timely issue that business owners face as they plan to exit their businesses. Investment banker, Joe Durnford, explains how business combinations work and how they can create unexpected value for the owners involved.

WEALTH PRESERVATION PLANNING VIA PRE-SALE TRANSFERS

by John H. Brown

Successful Wealth Preservation requires carefully considered answers to three basic questions:

1. How much Wealth do you want?
2. How much Wealth do you want the kids to have?
3. What tools are used to accomplish the transfer of Wealth?

To illustrate how one business owner answered these questions (and thus how Wealth Preservation Planning works in a fictional situation) let's look at the case of George Delveccio, a composite of a number of successful business-owning clients.

CASE STUDY

George opened our meeting almost apologetically. "I knew I'd waited too long to begin gifting part of the company to my kids when I met with my CPA. She told me that the company could be worth as much as $12 million to a third party. I had no idea! Since I don't need that much, I want to transfer at least half the value—at a lower valuation of course—before any possible sale. My CPA suggested gifting small amounts of stock using my $10,000 annual exclusion and perhaps part of my unified credit. She believed additional strategies might allow me to increase the amount of the gift without paying gift taxes so she suggested I meet with an experienced estate planning or tax attorney." Perhaps from a misguided sense of loyalty, George met with me.

I pointed out that the use of the $10,000 annual gift exclusion and the early use of the unified credit equivalent against gift and estate taxes of $675,000 were sound ideas, but, used alone, could not facilitate the transfer of a significant amount of wealth to the children. Even combining George's exclusion amount with Eunice's (his wife) the transfer to the kids would amount to less than $1.5 million.

The deficiency of this plan was further accentuated when I asked George what he thought the future held for his business. "The sky's the limit," George replied. This was telling given George's occupation—he owned an air freight expediter business. He strongly believed that the company's cash flow would continue to grow, from its current $2 million, by at least 25 percent per year for the next three years. "And that's what worries me. Given how much more valuable my business will be in a few years, won't it be even more difficult to transfer wealth to the kids? What I need to know is how I can give my kids as much as possible without paying any taxes."

My immediate reaction: "That's the best news so far." Before George thought I'd totally lost my mind, I explained, "The more rapidly your business is growing in value...the more cash it spins off...the easier it is to give it away and the more quickly you can give it away—with little or no gift tax consequences. But you are paying too much attention to the wrong issue—like most owners I've encountered."

To get George started on the right track, we started working on the three basic issues that must be resolved for successful Wealth Preservation Planning to occur.

EP PART I

How Much Wealth Do You Want?

The primary decision every business owner makes when transferring wealth to children is not how to accomplish the transfer, that's the attorney's job, but how much wealth to transfer to the children. Answering that question requires that you first revisit your own exit objective; namely, how much wealth you wish to have after you exit your business. The amount of wealth owners wish to leave their children usually (but not always) depends on how much the owners wish to have after they exit. As a general rule, I discourage parents from making significant gifts to children until their own financial security is assured. Only after the parents' needs are met do we ask how much is enough—or too much—for the kids.

Faithful readers know that the first step in Exit Planning is for the owner to determine his objectives. Failing to do so, means that an owner will not be able to leave his business in style. The three retirement objectives that every owner must fix in his mind are best phrased as questions:

1. How much longer do I want to work in the business?
2. What is the annual after-tax income I want (in today's dollars) during retirement?
3. Who do I want to transfer the business to?

As you can see, answering the second question establishes personal financial goals but it also provides the takeoff point for how much money the owner can afford to leave to children. Many owners draw upon the expertise of their financial or insurance advisors to work through these questions. Typically, these advisors run through a number of "what if" scenarios using different variables. Other owners prefer to use sites on the world wide web such as smartmoney.com to work through models that yield reasonable answers to the "how much will I need" question. No matter which type of analysis you use, the goal is to determine how much money you will need from the sale of your business.

EP PART II

How Much Wealth Do You Want the Kids to Have?

For many successful business owners, the question of how to leave as much money as possible to children begs the more important question. Given the huge (and perhaps unexpected) financial success of the business, the real question is how

much money should the children receive and how much is too much? As George put it, "I want to give the kids enough money to do anything, but not enough to do nothing." A noble sentiment, to be sure, but difficult to execute—at least without careful planning. In George's case, he preferred his children receive nothing to the prospect of creating "trust babies."

When owners wrestle with this question, I remind them that children need not receive money outright. Rarely are large amounts of wealth transferred to children freely or outright. Instead, access to wealth is restricted through the use of family limited partnerships (or limited liability companies) and the use of trusts. These tools are primarily designed to reflect the parents' desires to restrict their children's access to wealth. This is true regardless of the amount of wealth the parent wishes to transfer. Let's look at the steps in a typical "access/control" scenario.

STEP ONE First, the parents form a limited liability company (LLC) or family limited partnership (FLP) in which the parents own both the operating interest or general partnership interest as well as the limited partnership interests. Limited partners have no ability to compel a distribution, to compel a liquidation of the partnership (or LLC) or to vote. In short, limited partners enjoy few rights and have no control.

STEP TWO Children's trusts are created for the benefit of each child. The trusts will eventually own the limited partnership interests. A child will be entitled to receive distributions from the trust based on guidelines, parameters and restrictions that the parents prescribe in each trust document. These restrictions can be of several different types.

- Distributions based on age. Perhaps the most common, this restriction limits a child's right to gain access to funds held in the trust. Typically distributions are made over a series of ages, for example one-third of the trust principal at age 30, one third at age 40, and balance of the trust principal at age 50. The intent is that as children reach these ages, they will be sufficiently mature to handle the assets. Further, if a child mishandles an early distribution, he will learn from his mistakes and will not repeat them with later distributions. At least that's the idea.
- Recent articles in *The Wall Street Journal* indicate a rise in popularity of trust distributions to children tied to the child's achievement of written standards contained in the trust. These standards can take many different forms.
  - Parents may base trust distributions on a child's earned income. For example, if a child makes $60,000 annually in her employment, she would be entitled to receive an equal amount or some other percentage from the trust.
  - Distributions may be tied to the child's activities. For example, a parent may wish to distribute money to children who engage in (what the parent believes to be) socially useful activities: teacher in a public school, an artist, a writer. Generally, my clients deem that pursuing a legal career is not a socially useful activity despite my suggestions to the contrary.
  - Some parents require a child to enter into a premarital agreement before receiving any distributions from the trust.
  - Many parents forbid children from receiving any distributions they would otherwise be entitled to if convicted of a crime or addicted to an illegal substance.
- Distributions that create "safety nets." Many parents create safety nets for their children by giving children access to most of the wealth during their lifetimes (in the form of outright or periodic distributions) but retaining some portion in trust for the child for the duration of the child's life. This money is to be used only if all of the child's other sources of income are depleted. This type of a trust is commonly called a "Dynasty Trust"—or generation skipping trust since any assets remaining in this type of a trust after a child's death usually pass, tax free, to that child's children.

The variety of restrictions parents can place upon a child's right to receive money is limited only by imagination and any decision upon the degree of restriction. Keep in mind, however, that someone—known as the Trustee—needs to interpret, administer, invest, and make distributions according to the provisions of the trust. Your choice of trustee is at last as important as the trust design. The length of this article prevents a full discussion of desirable trustee characteristics and attributes. However, I suggest you consider the following:

- The degree of discretion you wish to give the Trustee to make distributions to the children;
- Length of trust;
- Value of the trust assets;
- Type of trust assets. For example, if an operating business interest is to be owned by the trust, the choice of Trustee may well be different than if the trust is comprised of investment assets;
- Desire to have a family member—or to not have a family member—be a Trustee;
- Trustee removal provisions—who will be entitled to remove the Trustee and for what, if any, reason.

STEP THREE After determining the restrictions they want in place, the parents transfer the limited partnership interests or non-voting interests into each child's trust. At this point the parent is making a gift of the value of the limited interest to the child. Unfortunately, parents with large

estates often abandon the planning process at this stage because they believe they can only transfer their combined "unified credits" of (roughly $1.5 million) to their children without incurring immediate tax consequences. (They calculate that they each enjoy a $675,000 lifetime exemption and can make tax-free gifts of $10,000 per child annually.) As demonstrated in Part III, however, parents are often able to transfer as much wealth to children as they desire. Once again, the toughest issue for parents to address then, is how much, when and under what conditions should their kids receive the dough.

There is one additional planning consideration that should be mentioned here. Under current estate tax law one spouse can leave assets at his/her death to the other spouse without estate tax consequences. For most estates, taxes are assessed only at the death of the surviving spouse. If, during their lifetimes, parents are able to give their children (and other heirs) as much wealth as they wish the children to receive, it is then possible to design an estate plan that gives the balance of the wealth at the first parent's death to the surviving parent. When the surviving parent dies, his/her loved ones (yes, your children!) will have received all of the wealth the parent wanted them to receive and the balance of the estate can be transferred to charity. Some families establish private foundations or give money to other charitable organizations.

The net result?

- The children receive what the parents want them to receive—during the parents' lifetimes;
- The parents enjoy 100 percent of the wealth remaining as long as either parent survives;
- After both parents die their wealth transfers to a charity of their choice—such as their own private foundation: and last, but not least,
- The IRS gets nothing.

For many parents and business owners this is an estate plan design worthy of close scrutiny. For George Delveccio, a man with strong charitable interests, this was the estate plan design that he chose to implement.

EP PART III

What Tools Minimize the Estate and Gift Tax Consequences of Transferring Wealth?

The key to transferring large amounts of wealth was discussed 2000 years ago by the patron saint of estate planning attorneys, Archimedes. Regarding leverage he observed, "Give me a place to stand and I will move the earth." Using leverage to move the earth or to move your wealth is the key to achieving noteworthy results. As we have discussed, each U.S. resident can give away, during lifetime or at death, $675,000 as well as their $10,000 annual exclusion.

In George's case, his CPA (also a Certified Valuation Analyst) valued the business at $9 million, a conservative but supportable valuation. The company's stock was recapitalized into voting and non-voting stock. Based on current tax case law, the CPA knew that she could justify discounting the value of non-voting stock (or a gift of a minority interest of the voting stock). In her opinion, the minority discount was 35 percent of the full fair market value of the stock. Thus, she reduced the size of the "earth" by 35 percent, and Archimedes was well on his way to leveraging the use of the Delveccio's lifetime exemption amount.

Even with the 35 percent discount, however, a gift of 50 percent of the company (now reduced to approximately $3 million in value) would exhaust George's and Eunice's combined exemption amounts of $675,000 each as well as cause the payment of a gift tax of approximately $750,000.

Like every other business owner, George was not particularly keen on paying a tax of $750,000. So he didn't. And he still gave away 50 percent of the company to his children. He did so by using the biggest lever in Archimedes' arsenal—the biggest lever in the "Wealth Preservation Transfer Game": a "GRAT"—a Grantor Retained Annuity Trust.

Here's how GRATs work:

After first obtaining a professional valuation of his company George created a GRAT. A GRAT is an irrevocable trust into which the business owner transfers his stock. George transferred all of his non-voting stock which represented 50 percent of the overall ownership interest in the company. The GRAT must make a fixed payment (annuity) to the owner each year for a pre-determined number of years. At the end of this time period, which is established when the trust is created (usually 2 to 10 years), any stock remaining in the trust is transferred to the children. A gift is made when the stock is transferred into the GRAT. The amount of the gift is the value of the asset transferred minus the present value of the annuity which the owner will continue to receive. To calculate this present value the IRS requires the use of its federal mid-term interest rate (currently 7.4 percent). The owner acts as the Trustee (the person in charge of the management of the trust assets, in this case the stock of the company).

Using George as an example, he transfers his non-voting stock, valued at $3 million, into his GRAT. The amount of the gift is determined when the GRAT is funded. For Delveccio, we designed a GRAT, funded it with $3 million of stock and required a $1 million annual payment for four years. Recall that the $1 million distribution amount is the amount of dividend distribution the company normally made with respect to one-half of the stock. Consequently, all of the stock originally transferred to the GRAT will still be there after four years. The IRS, however, must assume that a $3 million asset will produce only $225,000 of distributions/growth a year. (It bases that assumption on its current 7.4 percent federal mid-term interest rate.) Consequently, designing the GRAT to generate an annuity payment of $1 million per year means that the GRAT theoretically distributes—using the IRS's interest assumptions—roughly $800,000 of the GRAT's principal (the non-voting stock) in the first year of the GRAT. In each of the ensuing three years, even more principal will be distributed to satisfy the annual annuity payment until, theoretically, the principal of the GRAT is exhausted. As you can see, if the IRS's assumption is correct, all of the GRAT assets must be distributed to satisfy the annual $1 million annuity payment.

Of course, if George's company maintains its capacity to pay its regular distribution of $1 million with respect to 50 percent of the stock, all of the stock will remain in the GRAT after the four year GRAT term. For gifting purposes, however, we are entitled to use the IRS's interest assumption. This results in nothing being left in the GRAT, and therefore no gift was made at the time the GRAT was created. In George's situation, when the GRAT terminates four years hence, the remaining stock (in this case ALL) is transferred to the children without further gift consequences. The children will receive one-half of the company at no gift tax cost.

The key to making a GRAT work well is to have an asset which appreciates in value and/or produces income in excess of the federal mid-term interest rate. Many, probably most, successful businesses can easily exceed this IRS mandated threshold. This is especially true when we design the gifting to take advantage of the additional leverage in the form of using a minority discount on the original transfer of the business interest to the GRAT.

Let's summarize what George did:

1. He transferred one-half of a business with a fair market value of $9-$12 million to his children in four years using less than $100,000 of his lifetime exemption.
2. He continued to receive all of the income from the company during that four year period.
3. At the termination of the trust (four years) the trust asset, consisting of non-voting stock, was transferred to trusts for George's children. These trusts were in turn established by George when the GRAT was created and contained his wishes regarding when, and if, the children were to receive money from those trusts.

EPILOGUE

The assets in George Delveccio's estate did indeed continue to grow. He was able to transfer wealth equal to $3 million to each child in trust. After the business was sold, he and his wife, Eunice, were able to invest $5 million, far more than they required to maintain their relatively simple lifestyle. In fact, George and Eunice have made tentative plans to establish a foundation and give additional wealth during their lifetimes to the charities of their choice.

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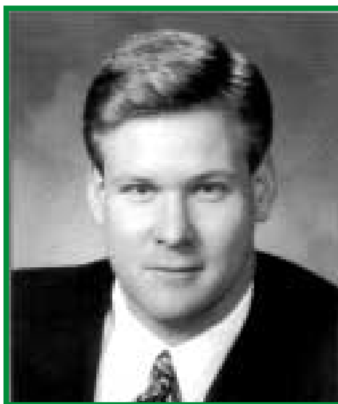

CREATING VALUE THROUGH COMBINATIONS

by Joseph Durnford, CPA, CVA

Recently, our firm was hired to sell a large building products distribution company. This well-respected company was its region's leader in overall market share, revenue dollars, number of facilities and number of employees. Not surprisingly, when a number of other industry heavy hitters decided to consolidate the industry by creating a Poof Company (see **The Exit Planner**, July 1998), they invited our client, Jerry Bush, to be among the founders. After attending the first organizational meeting, Jerry determined that "Poofing" did not achieve his exit

objectives but that selling out to one of the heavy hitters for cash certainly would. Given that a number of big guys were actively trying to get bigger, Jerry justifiably assumed that he could sell his company for a premium price—using geographic location and quality of his business as prime selling points.

After several months of preparation Jerry was ready to go to market and invited several suitors to a controlled auction we created to maximize the likely sale price. At first, the process attracted numerous interested buyers. Four of the potential buyers were strategic industry players, one of which was publicly traded and the other three privately held. One financial buyer arrived at the table planning to use Jerry's company as a platform to launch his consolidation of the industry.

As the auction progressed and the sale price spiraled, bidders became skittish. When sticker shock forced several bidders to drop out we thought that we had reached the sale price peak. Left standing was the publicly traded company until a funny thing happened on the way to closing. The owner of the third largest competitor in Jerry's market called to ask if our firm could help him sell his business. Both the publicly traded bidder and one of the other strategic bidders had contacted this owner in an attempt to enter the market at a lower purchase price. Given the high price of Jerry's company, they reasoned that it might be cheaper to buy a smaller, albeit well run, company and then just fight for market share.

We immediately informed Jerry of this development. His sale was suddenly in jeopardy, yet combining his company with his competitor's and presenting both to interested buyers might just raise the value of each—beyond what either would be worth as stand alone companies.

Obviously, this situation presented both risk and opportunity. If the bid for the number three player moved forward, Jerry's auction would fail for lack of participants and he would receive far less than premium price. The opportunity was for the number three player to piggyback on to Jerry's auction and boost the valuation multiples of both companies.

With Jerry's permission and active participation, we decided upon a course of action to mitigate the risk and exploit the opportunity. We contacted the number three player and proposed that both companies sell themselves as a package. Packaging the companies not only consolidated 50 percent of the geographic market share, but it also bolstered some of the operational weaknesses present in each of the companies. The two companies together now controlled the access to the market. The only way for a buyer to gain a sustainable market presence was to buy the two-company package. Effectively, we had bolted the back door while making the front door even more attractive.

After formalizing the agreements between Jerry and his former competitor, we informed the bidders of the "new opportunity" to control the market and to lock out the competition. Our announcement thrilled none of the bidders but they all acknowledged that the consolidation of the market made a more attractive deal.

Packaging the companies enabled us to create a robust auction for both businesses. Both companies were sold to one of the privately-held strategic buyers in an all-cash transaction, at a premium price. In fact, this buyer was one who had dropped out of the bidding because the price was too rich when there were other ways to penetrate the market. Once we combined the two businesses, the buyer's CEO observed, "We had no choice but to pay whatever it took to capture this opportunity."

The story has several morals. First, creativity and flexibility in the deal making process are critical. Second, business combinations can create unforeseen value for owners, even as they exit their businesses. In today's competitive merger and acquisition marketplace, one plus one sometimes does equal four.

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