The Tax-Exempt Private Stock Market & Business Success(ion)

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The Jepson Alumni Center
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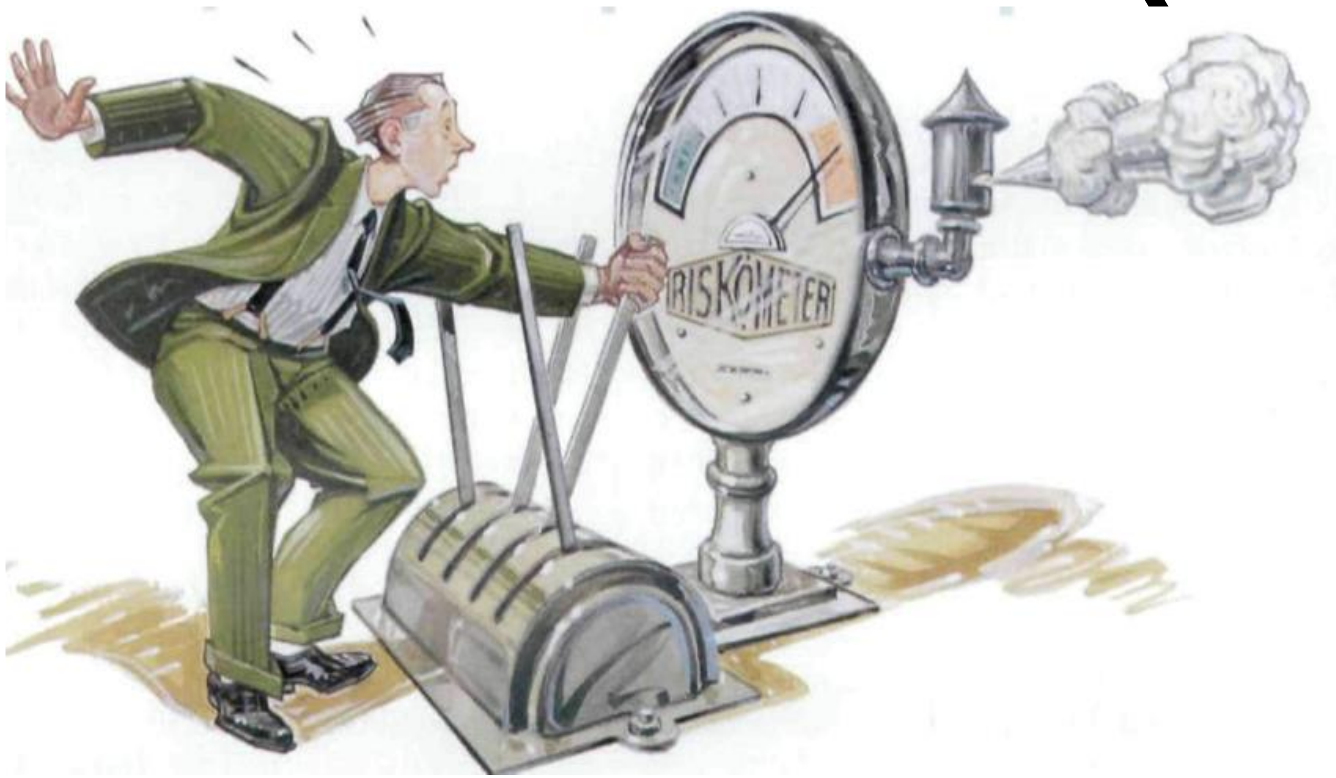
Business Success(ion)

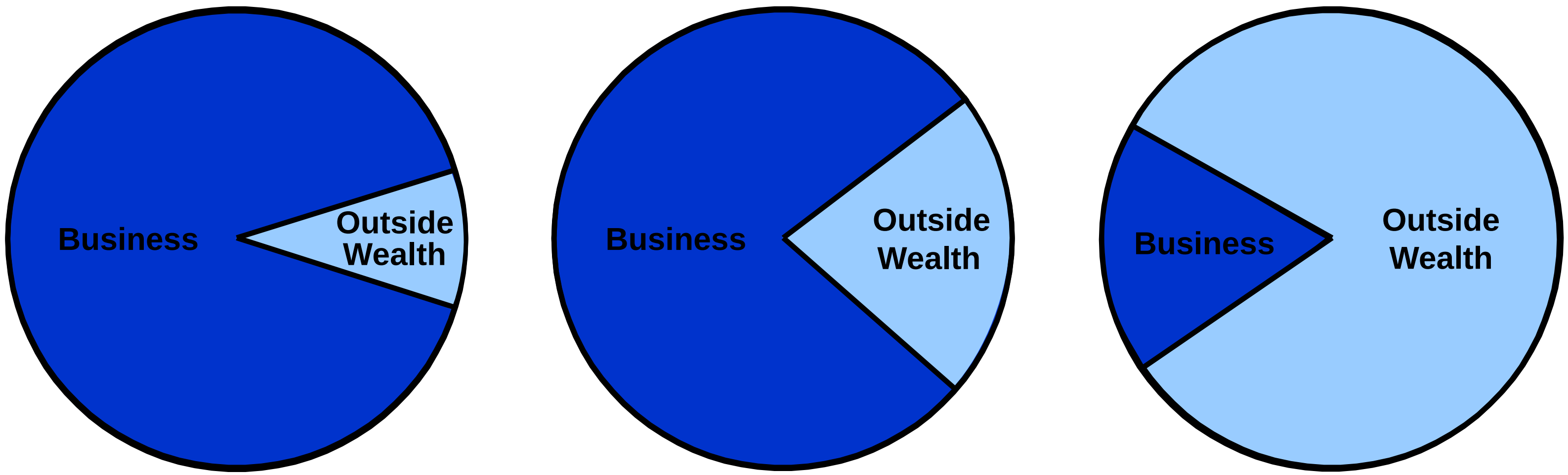


1. **It's Complicated.**
2. **Arriving at Any Solution Involves Navigating through Several Disciplines and Their Interactions.**
3. **It Asks the Owner(s) Emotionally, Legally and Financially Difficult Questions.**

Business Success(ion)

1. At any given time, 40% to 50% of U.S. businesses are facing a transfer of ownership.
2. Less than 1/3 of closely-held family businesses survive the transition from first to second generation ownership.
3. Plans are unclear – For CEOs who are:
    - Retiring in 5 years – 42% have no identified successor
    - Age 60+/- 28% have no successor
4. In 25% of the cases, involving a closely-held business, the successor has no full-time work experience outside the company.

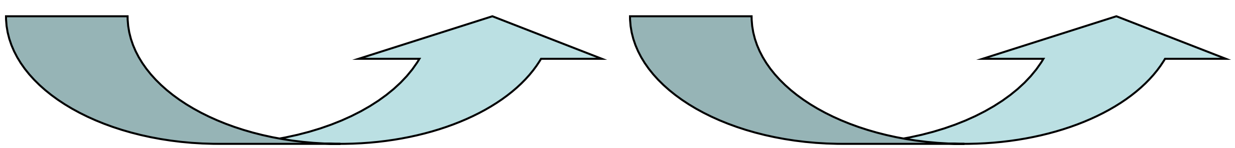
Percent of Owner's Net Worth



Age 40
Business Growing

Age 50
Business Successful

Age 65
Business Transition



Growth is Taxed

Transition is Taxed

And Death is Taxed

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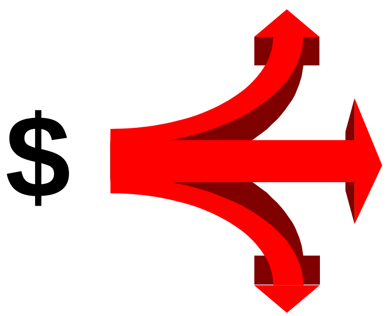
PRIVATE CORPORATIONS

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

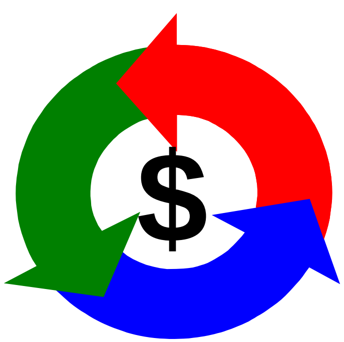
- Corporate Income Taxes
- Personal Income Taxes
- Capital Gains Taxes
- Gift Taxes
- Estate Taxes
- Generation Skipping Taxes......

These are Seldom Addressed in an Integrated Fashion

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



Rather than allow divergent plans to bleed dollars off in all directions from the corporation and the shareholders...



Implement coordinated strategies tailored to balance corporate and personal financial/philosophical objectives.

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TAX SHELTERED SALE OF STOCK TO AN ESOP

1. **An ESOP is a qualified retirement plan under IRC Section 401(a) designed to invest primarily in company stock.**
2. **Stock and/or cash contributions are tax-deductible to the sponsoring company, as are C corporation dividends in some cases.**
3. **Earnings on S corporation ESOP shares are untaxed.**
4. **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 AN ESOP

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

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

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

What Many Companies Do… The Plain "White Bread" Management Buyout.

Rising management buys 1.0 Million of stock from the owner using seller financing: 10-year note at 5.7%.

1. **The buyer earns \$2.0 M ordinary income over the decade, pays deductible note interest of \$340 K, taxes of \$667 K, and principal on the seller note of \$1.0 M.**
2. **The seller pays ordinary income taxes on the interest income (\$340 K X 40% = \$156 K) and capital gains on the note principal (\$1.0 M X 25% = \$250 K)**
3. **Total taxes paid on the transaction by both parties are about \$1.05 M.**
4. **If the stock grew at 7% over 10 years, the buyer could sell the resulting \$2.0 M (cost basis of \$1.0 M) and net about \$1.8 M.**

SO FOR TOTAL TRANSACTION TAXES OF OVER \$1 M, THE BUYER GOT THE STOCK… KEPT NOTHING OF \$2 M OF ORDINARY INCOME OVER A DECADE AND HAS A POTENTAL NET OF \$1.8 M FROM A STOCK SALE.

TAX SHELTERED SALE OF STOCK TO AN ESOP

Instead of all parties paying about $1 M in taxes on a $1 M Management Buyout, suppose you could:

1. **Get a tax deduction for all stock purchases?**
2. **Use untaxed dividends (including S distributions) to buy stock?**
3. **Allow the company/family to keep local control (not sell away)?**
4. **Allow the seller to defer capital gains taxes?**
5. **Improve the retirement plan?**

Should you be seduced by the “Siren Song” of tax savings?

With All the Tax-Savings, What's Not to Like? Do the Pros Really Outweigh the Cons?

Not Necessarily!

1. **ESOPs are quite complex and that ceiling of complexity is often an impediment to their successful operation.**
2. **ESOPs are subject to IRS and DOL regulations; the latter agency is aggressively auditing these plans.**
3. **Costs: ESOPs are not for small companies, i.e. less than about 30 employees or profits below about $500 K.**
4. **The Board of Directors and the ESOP Trustee(s) they appoint are <u>fiduciaries</u> (as for a 401(k) plan) with significant personal responsibilities.**
5. **Repurchase obligations: Stock in a retirement plan has to be <u>repurchased</u> to deliver on the promised retirement benefit.**

So When Do They Work Well?

1. When the selling shareholders are willing to work through a longer term process than an outright sale.
2. When the sellers are willing to accept a reasonable “Fair Market Value” negotiated by an Independent Transaction Trustee (based on an independent representation of value)
3. When the rising management is appropriately incentivized with discretionary performance-based rewards for continuing to push the stone up the hill.
4. When the company is willing to accurately communicate the program to all employees (not necessarily open up the books).
5. When the cost/benefit ratio of the program is obviously favorable.
6. When the deal design incorporates all possible shareholder objectives, e.g. the estate planning, and is not ‘over-leveraged.’

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Pros & Cons

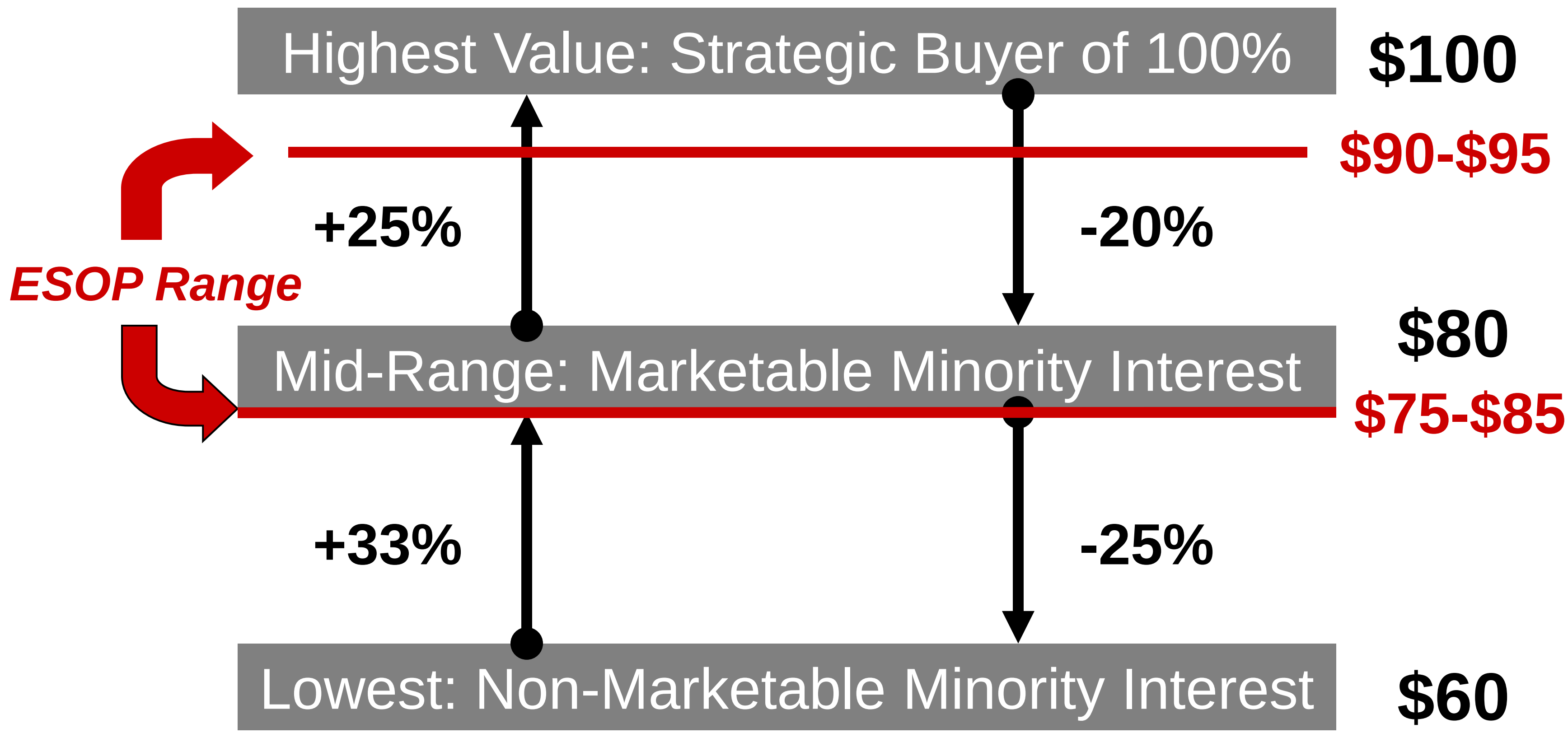
If I can sell to rising management, an ESOP or a third party…what's the business worth?

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.

3. Be careful with deals where a representation is made that an ESOP can mimic the value from a strategic sale (generally a highly leveraged transaction).

Private Equity Interest Valuation
Three Basic Levels of Value
Non-ESOP Discounts vs. ESOP Discounts



These percentages illustrate approximate ranges of independent valuations of closely-held corporation stock for family gifts, key executive stock plans, sales to an ESOP. Discounts for ESOP interests are typically lower since the ESOP must be assured a market for the shares and is an economic, not a strategic buyer. See Chris Mercer's data (mercercapital.com) for a more accurate description of multiple levels of value.

How to Coordinate Valuation, Taxes, Family Wealth Preservation and Your Return on Equity from 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 the Owners’ Company and Their Money:

a) 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.

b) 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.

c) Most lenders are asset-based lenders and look for balance sheet or seller support of the deal.

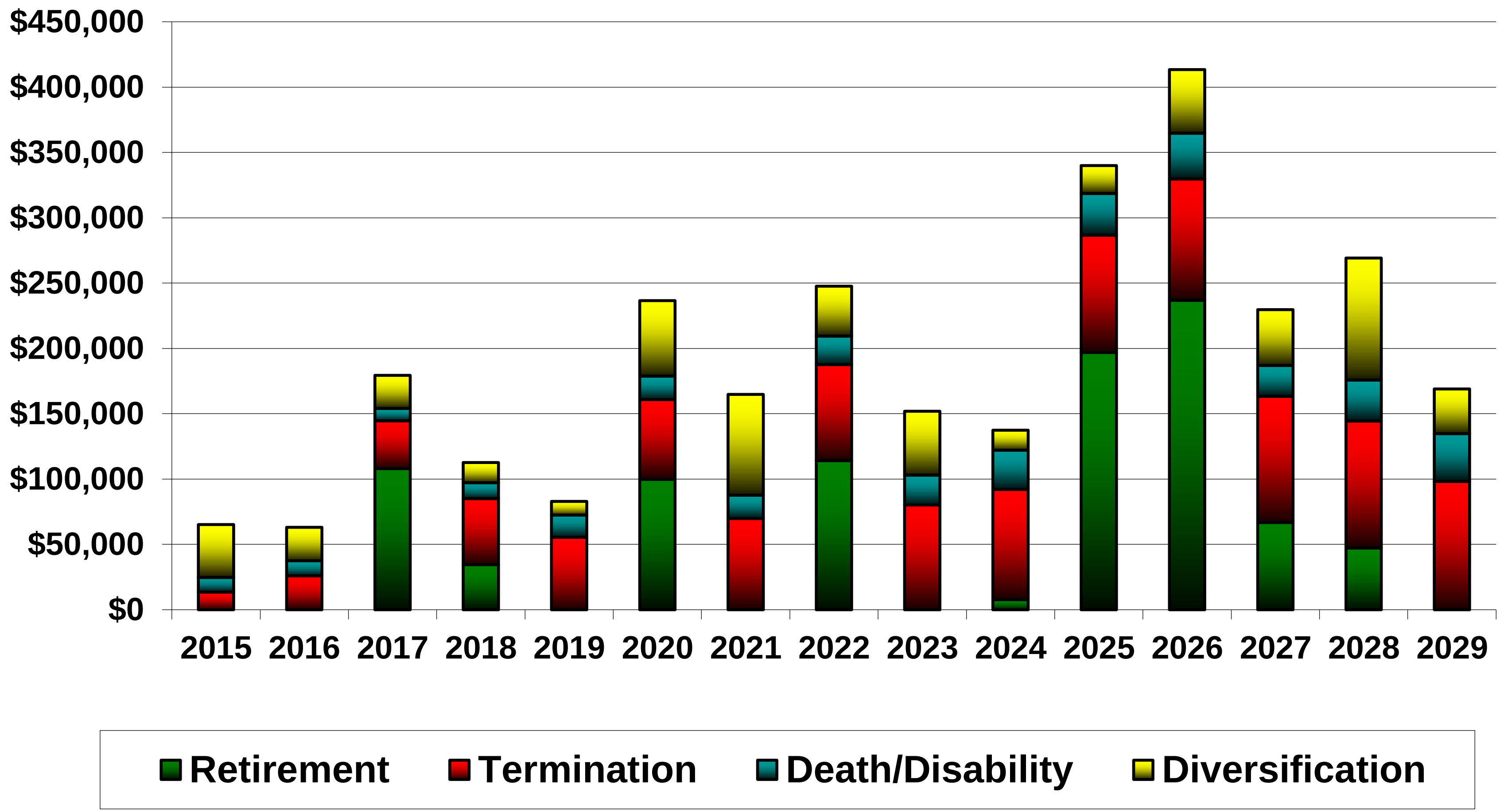
d) ESOPs not generally a take-the-money-and-run solution for majority shareholders.

e) 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 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. This Can Be Managed Using Prudent Funding and Key Executive Plans.

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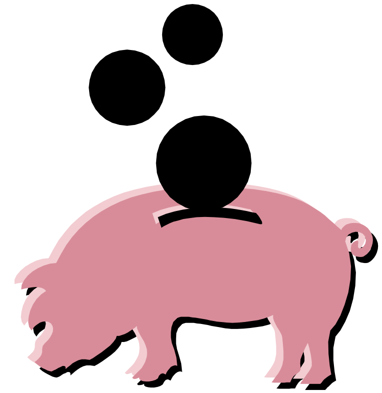
APPENDIX

The following slides will not be exhaustively analyzed.

They are here simply to indicate some of the successful applications of ESOPs in carefully planned business continuity structures.

The Tax-Free ESOP Cash Warehouse



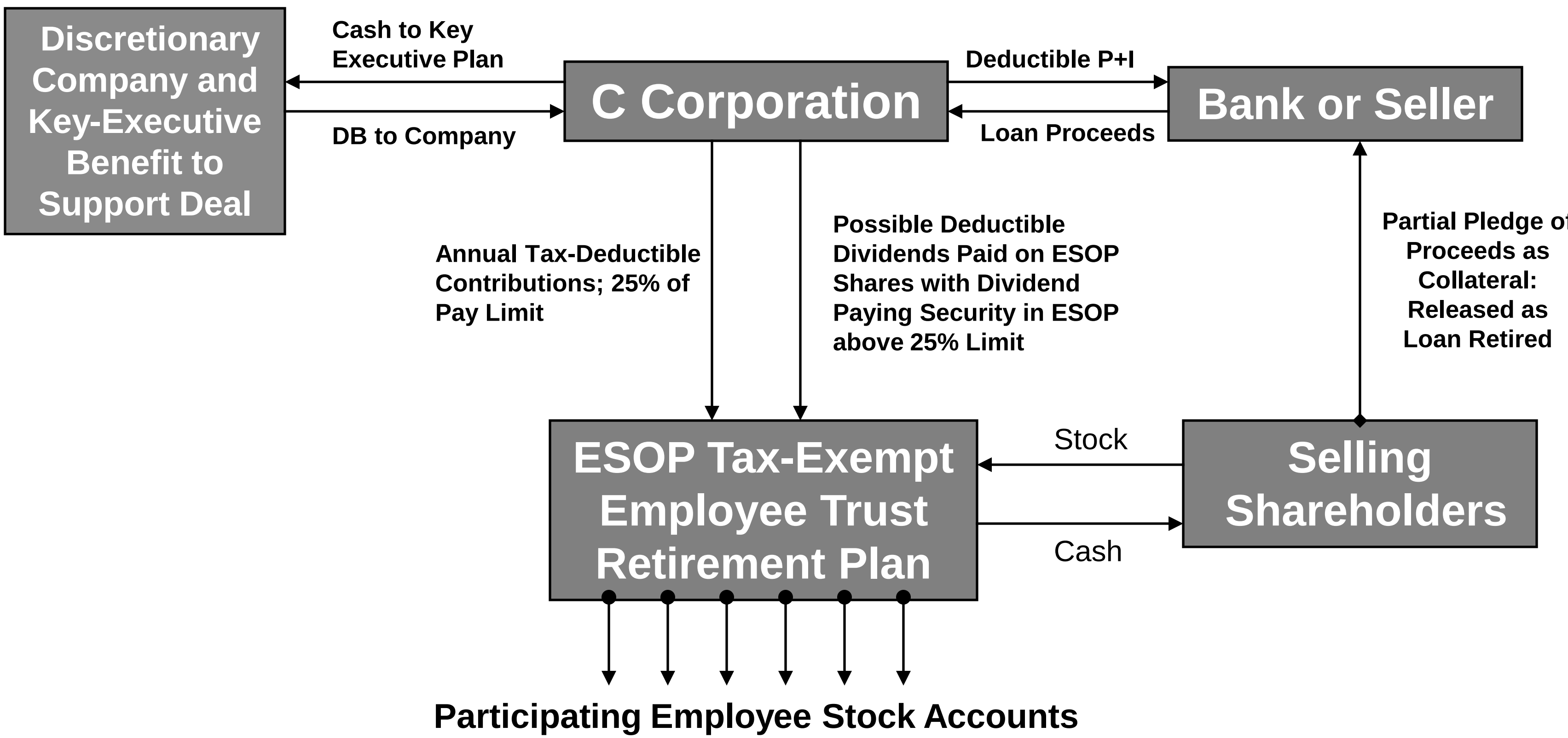
If you have a little time, two, three or four years:

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.

Building Your Own Buyer

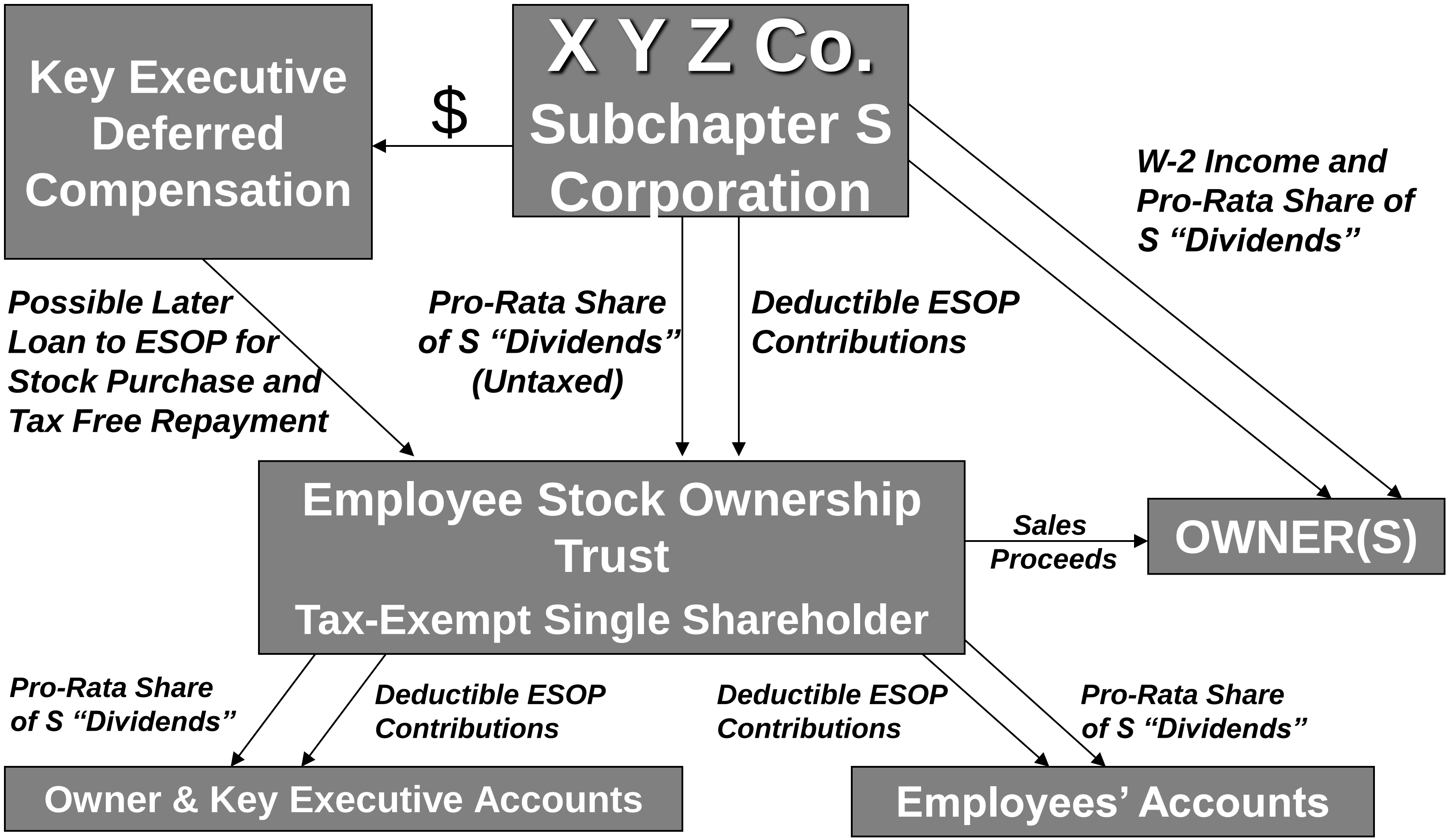
C Corporation Leveraged ESOP Stock Purchase



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

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 compensation) plan will need ongoing coordination to comply with this interpretation of EGTRRA 2001 reflected in IRC §409(p).

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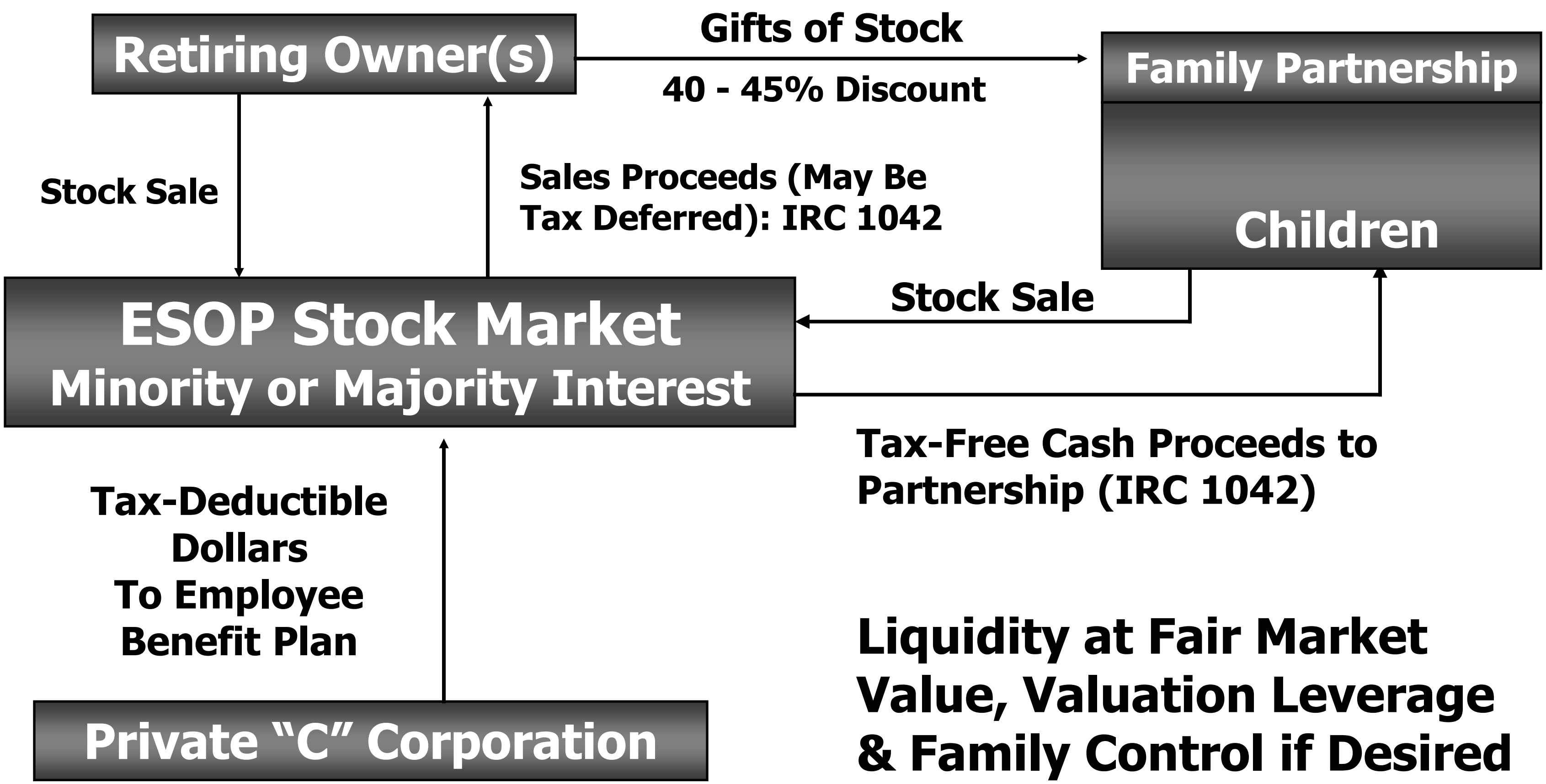
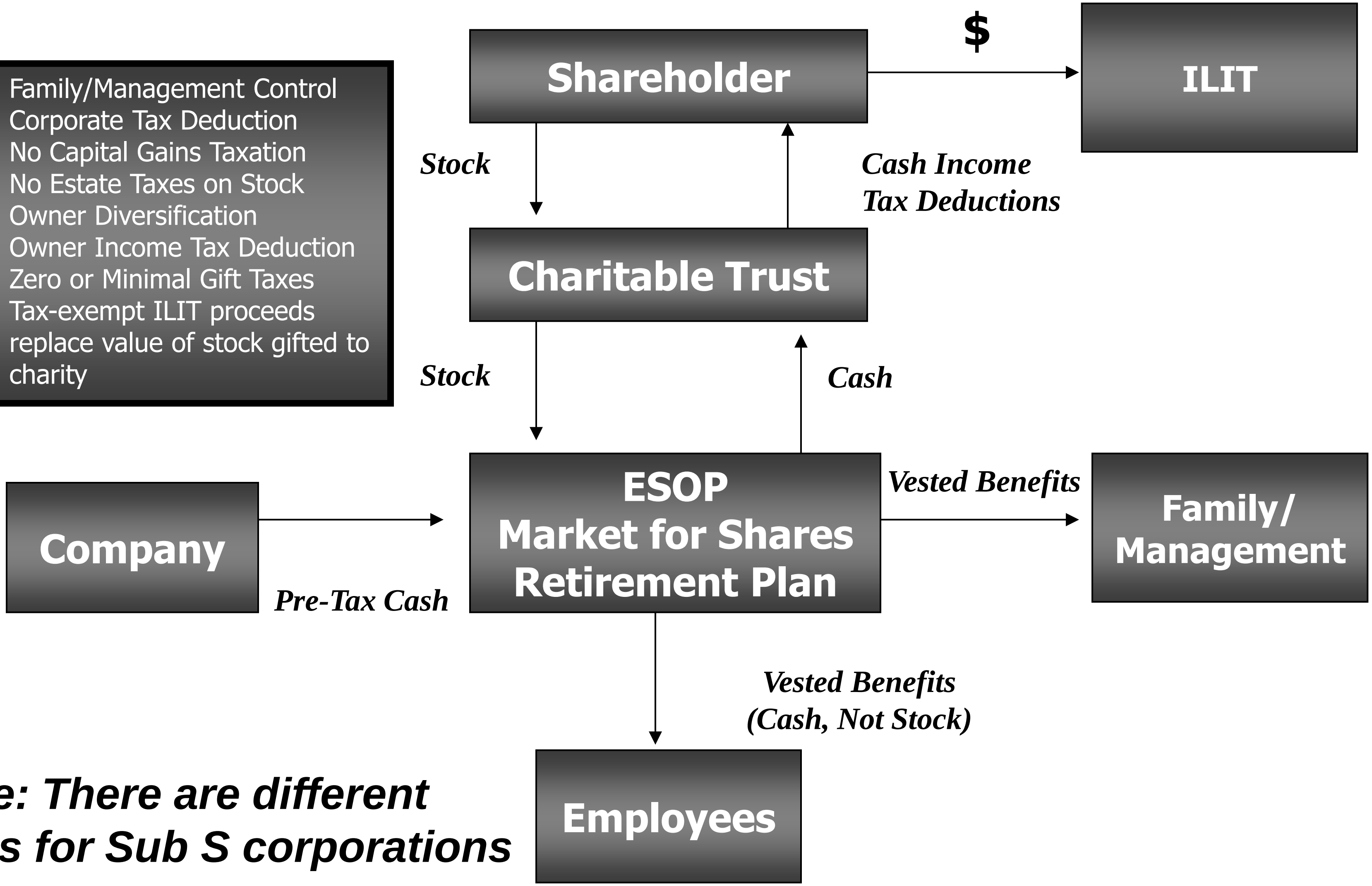
The Family Limited Partnership + Employee Stock Ownership Plan



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

Tax Shielded 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



Note: There are different rules for Sub S corporations

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

1. Work with specialists who have genuinely ‘been there, done that’ and
2. Take a comprehensive approach in coordination with your trusted advisors.
3. Coordinate your business continuity and capitalization with both personal and corporate strategies:
   a) Conversion of your equity to cash at the fair market value.
   b) Key executive gain-sharing and deferred compensation.
   c) Your family estate planning.
   d) Rank-and-file compensation and benefit packages.
   e) Need for rising management to assume your role and obligations.
4. Take care that business appraisals are independent and tailored to the transaction you desire.
5. Be prepared to deal with complexity and work through a ‘process.’

Thank You!

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