

# **Business Succession**

Columbus Chamber of Commerce

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# Business Succession Agenda



# Steps in Business Succession



# Business Succession Agenda



- Successor Management
- Internal Transfers
- Outside Sale
- ESOP Benefits & Basics
- ESOP Transactions
- Business Valuation
- Legacy Planning
- Case Studies

# Business Succession Scorecard

- Price (net) & Liquidity
- Tax Efficiency
- Family Care
- Employee Care
- Customer Care
- Continued Control
- Business Longevity
- Business Legacy

# Step 1: Management Succession

- Recruitment and Development of Management
  - Family v. business priorities
  - The management life cycle
  - Culture builders
  - Performance incentives



# Step 1: Management Succession

- Professionalization of Management
  - Independent & outside directors
  - Limits on self dealing by corporate fiduciaries
  - Board committees
  - Corporate formalities



## Step 2: Ownership Transfers

There are a lot of options

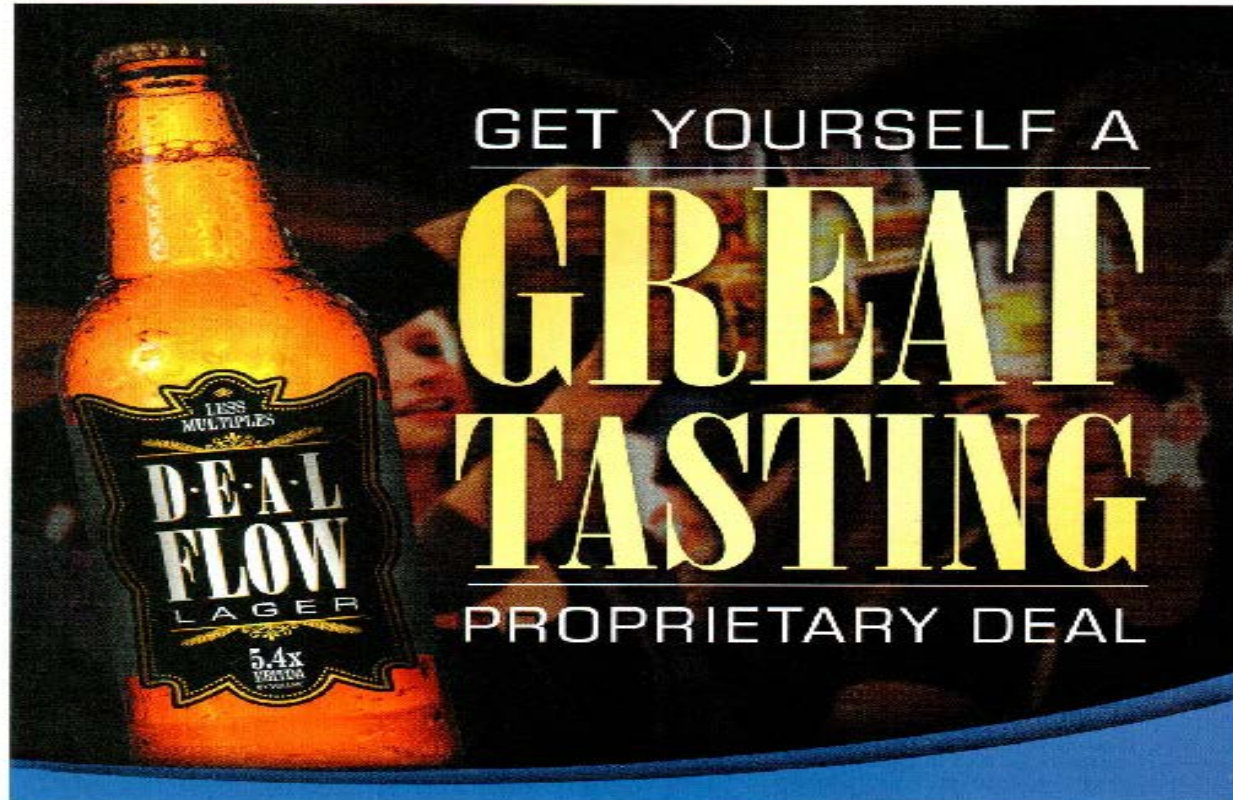




# Internal Ownership Transfers

- Cross Purchase Agreements & Redemptions
  - Price & liquidity medium
  - Tax efficiency low to very low
  - Continued control variable
- Family Trusts & Gifts
  - Price & liquidity low
  - Tax efficient until liquidity event
  - Continued control variable
- Life Insurance Liquidity

# Outside Sale (Stock or Assets)



# Outside Sale (Stock or Assets)

- **Strategic Buyer**
  - Price & liquidity high
  - Customer care fair to good
- **Financial Buyer & Private Equity**
  - Price & liquidity medium to high
  - Customer care fair to uncertain
- **Common Scorecard Attributes**
  - Tax punitive if sale of C corp assets
  - Little to no continued control
  - Earn-out and indemnification issues
  - Employee care uncertain
  - Loss of business culture and legacy

# Sale to an ESOP

- Hybrid Inside/Outside Sale
  - Seller selects the Buyer
  - Buyer, Seller and Obligor
- Common Scorecard Attributes
  - Price & liquidity medium to high
  - Tax efficiency very high
  - Continued control is standard
  - High employee care and customer care
  - Enhances business culture and legacy

# ESOP Benefit – No Federal Taxes





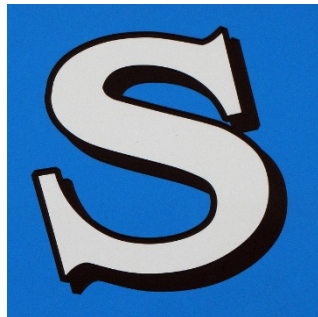
# Benefits of an ESOP

- 100%, S Corp ESOP company
- Pays no federal income taxes
- This is legal



# Benefits of an S Corp ESOP

- Passed by Congress in 1998
  - Corporate income/loss passed through pro rata to shareholders
  - Shareholders receive cash distributions without additional tax
  - ESOP is tax exempt trust – no need for cash distribution
  - Corporation may retain profits for other purposes



Corp ESOP

=



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# Benefits of a S Corp ESOP

- No corporate income tax
- No income tax to ESOP trust
- No deduction for profit distributions
- Profit distributions to participant accounts
- Loan repayment for distributions on unallocated and allocated stock
- Loan interest included in 25% contribution limit
- Allocation restrictions under Code Section 409(p)
- No tax-free or tax deferred stock sale to ESOP

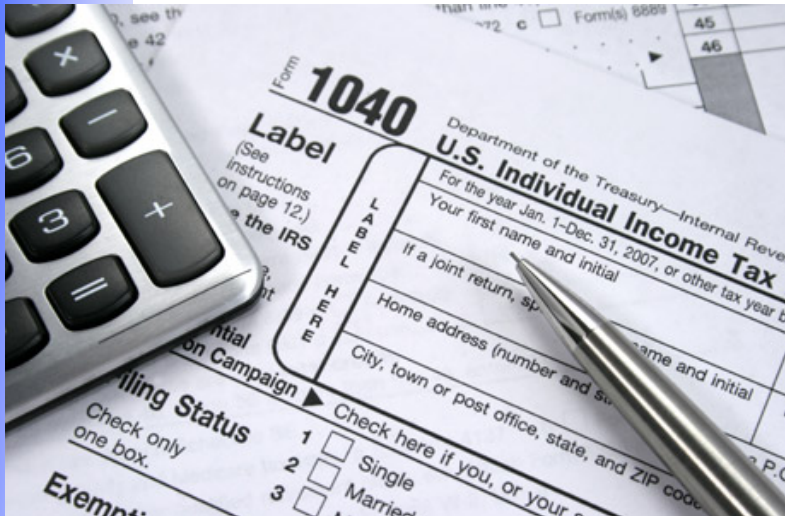


# Other ESOP Tax Benefits

- Capital gains deferral
- Principal deduction on ESOP loans
- Tax-free growth of employee accounts
- Higher contributions to employee accounts



# Benefits of an ESOP – 1042 rollover



- Sell at least 30% to an ESOP
- No capital gains taxes on sale
- Must be C corporation
- Must invest proceeds in U.S. operating companies
- Can borrow against portfolio



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# Benefits of an ESOP – 1042 Example

	1042 sale	No 1042
Sale	3,000,000	3,000,000
Basis	<u>500,000</u>	<u>500,000</u>
Capital gain	2,500,000	2,500,000
Taxes (20%)	<u>0</u>	<u>500,000</u>
Net to you	\$2,500,000	\$2,000,000



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# Benefits of an ESOP – 1042 rollover

- Three-seller year holding period
- No allocation of 'tainted shares' for 10 years from sale
  - 25% shareholders (no 10 year rule)
  - Sellers electing §1042 treatment
  - Family members of selling shareholders
- Becomes exempt upon gift of QRP or death of taxpayer (step up basis)

# Benefits of an ESOP = 1042 rollover

- 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

**A 1042 Rollover Can Generate  
Significant Tax Benefits for You**

# ESOP benefit – business continuity



- Avoid selling to outsider who may want to change things
- Management can remain in place
- Board prior to sale, including sellers, can remain
- No need to change culture or operations
- Better than business as usual

# ESOP benefit - Flexibility



- ESOP willing to purchase any percentage of business
- Minority, majority, 100%
- Doesn't require control sale
- Can buyout partner, family member or shareholder
- Can do transition in stages
- Tax benefits geared to different levels of ownership

# So, What Exactly Is an ESOP?



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# ESOP Basics

- Qualified Employee Benefit Plan
- Operates under a Tax Exempt Trust
- Can invest solely in Employer Stock
- Can Borrow Money to Buy Stock
- Market Maker for Company Stock
- Tax Benefits for Selling Owners
- Tax Benefits for the Company
- Employee Incentive Plan

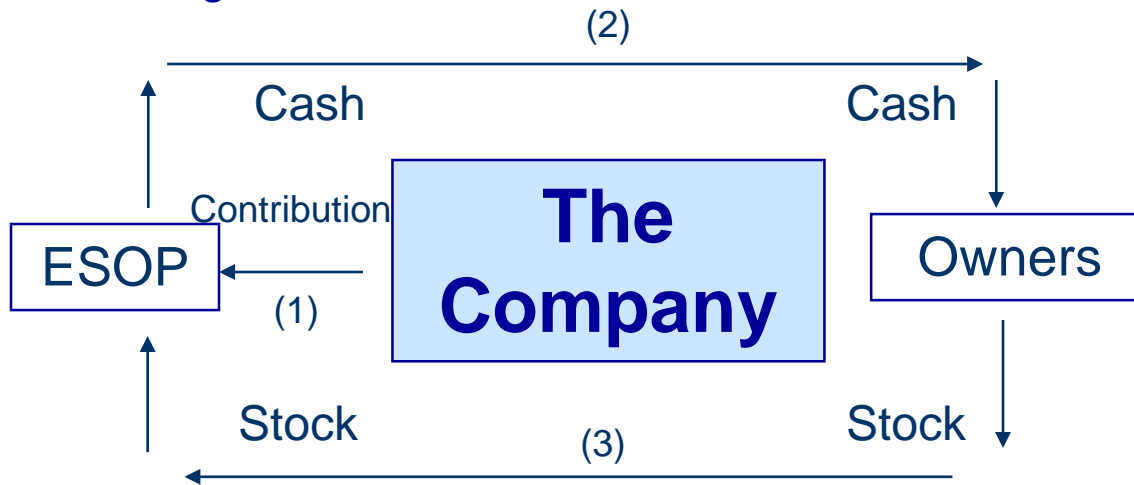
# ESOP Basics

- Governed by Internal Revenue Code (enforced by IRS) and ERISA (enforced by DOL)
- Defined contribution plan under Code Section 401(a)
- ESOP trust is tax exempt under Code Section 501(a)
- Exempt from certain prohibited transactions under ERISA Section 408(b) and Code Section 4975(d)

# Basic ESOP Transaction

## Employee Stock Ownership Plans

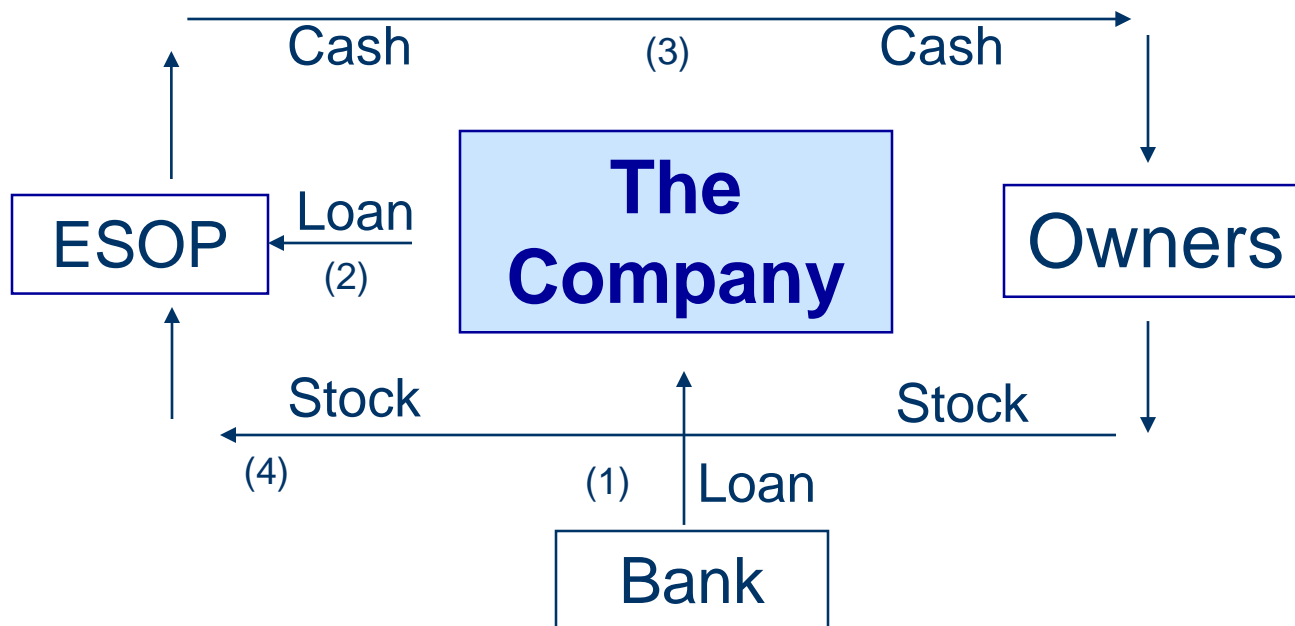
Non-Leveraged



- Contributions limited to 25% of eligible compensation
- Contributions deductible
- May 'pre-fund' ESOP
- Convert existing profit-sharing plan/purchase stock

# Leveraged ESOP Transaction

## Employee Stock Ownership Plans Leveraged



- Loan principal deduction up to 25% of comp
- Additional 25% deduction for additional DC plan
- C Corp – unlimited interest deduction
- C Corp – reasonable dividend deduction
- S Corp – interest included in 25% contribution



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# How Much Is Your Business Worth?



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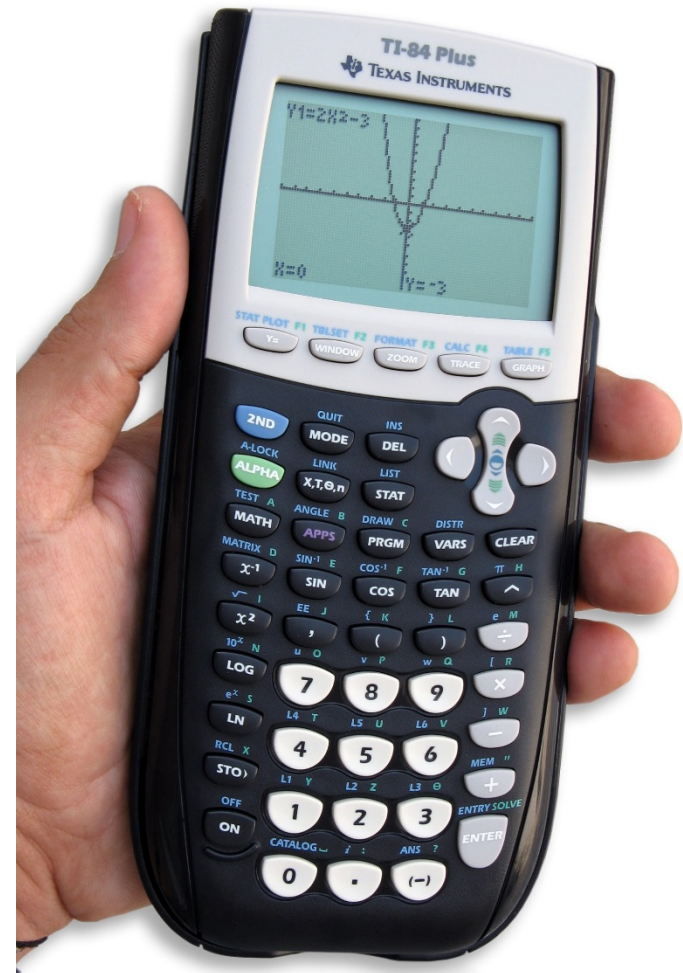
# Business Valuation for ESOP

- ERISA Section 3(18) “adequate consideration” standard
- Code Section 401(a)(28) independent appraiser standard
- IRS Rev. Ruling 59-60 and DOL Prop. Reg. 2510.3-18(b)
- Requirements for valuator of stock for ESOP
  - Advisor to trustee and not to company or seller(s)
  - Trustee, not valuator, determines value of stock
  - Valuator must be professional business appraiser with no interest in the transaction or the parties



# Business Valuation

- USPAP (AI) and SSVS (AICPA)
- Income (Intrinsic) Approach
  - Capitalized income method
  - Discounted cash flow method
- Market Approach
  - Transaction method
  - Guideline company method
- Asset Approach
  - Orderly liquidation method
  - Adjusted net worth method



# Step 3: Legacy Planning



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# Step 3: Legacy Planning

- 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
  - Younger spouse outlives children
  - Legal / accounting expense
  - Family conflicts
  - Funding of B trust fluctuates with exclusion amount

# Step 3: Legacy Planning

- Charitable Remainder Trusts (CRT)
  - Annuity trust
    - fixed dollar payments (at least 5% but not more than 50% of assets)
    - no additions to corpus
  - Unitrust
    - at least 5% of assets or, if less, trust income
    - additions permitted to corpus
  - CRT cannot own S corporation stock

# Legacy Planning - CRT

- 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
- Present value to charity must be 10% or greater



# Legacy Planning – Family Limited Entities

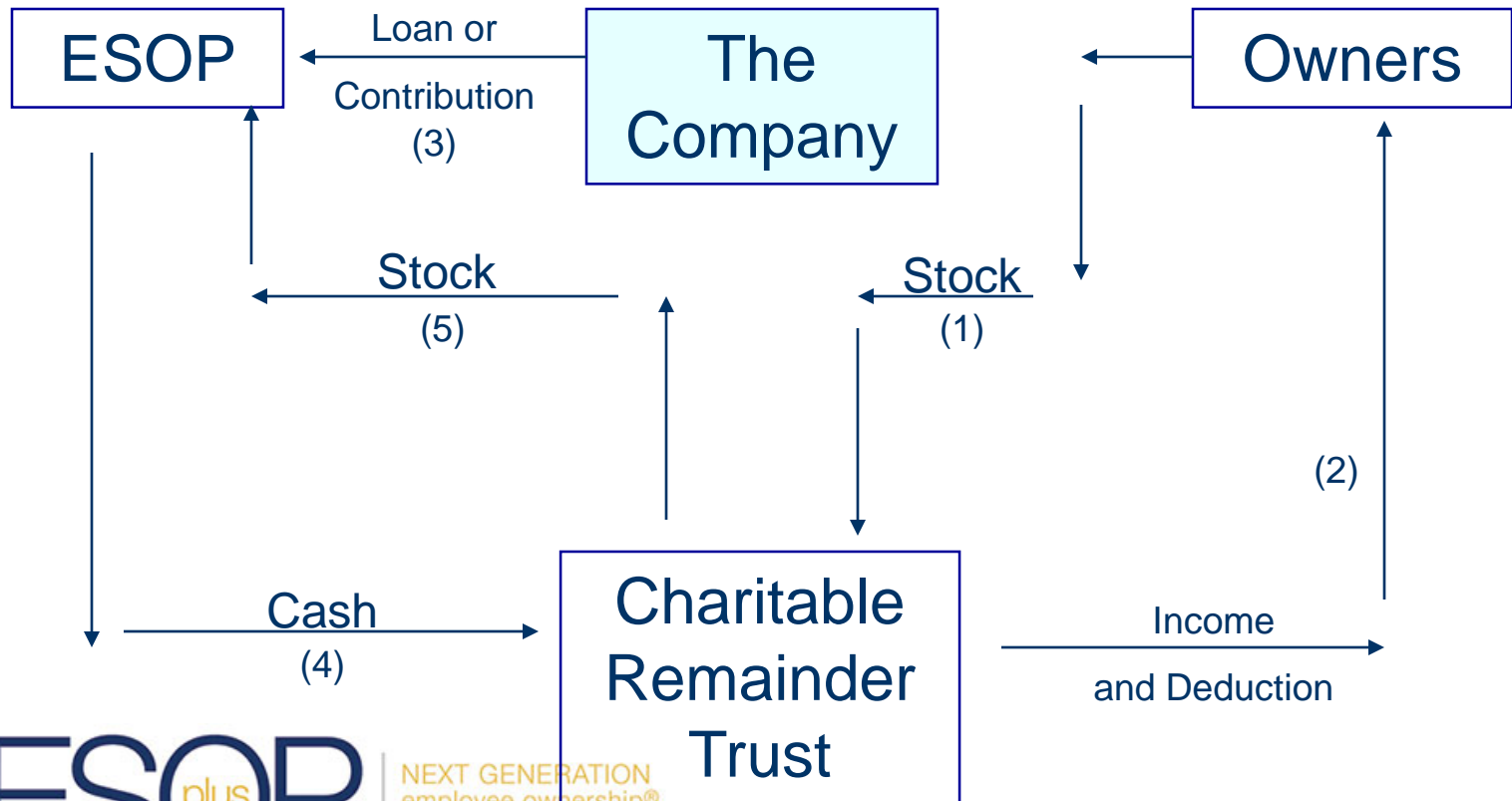
- Family Limited Partnership (FLP)
- Family Limited Liability Company (FLC)
- Advantages:
  - Shield assets from creditors
  - Valuation discounts for gifted interests
  - Harder for donees to spend gifted interests
  - Provide centralized asset management
  - More flexible than irrevocable trusts
 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

# Legacy Planning

- Irrevocable Life Insurance Trust (ILIT)
    - Proceeds outside the estate if requirements met
    - Transferred policy and premium payments are gifts
    - Transfer existing policy at least 3 years prior to death
    - New policy not a gift, but premium payments are gifts
    - If incidents of policy ownership such as power to:
      - Change beneficiary
      - Borrow against policy
      - Transfer policy
- Then, policy proceeds included in the estate

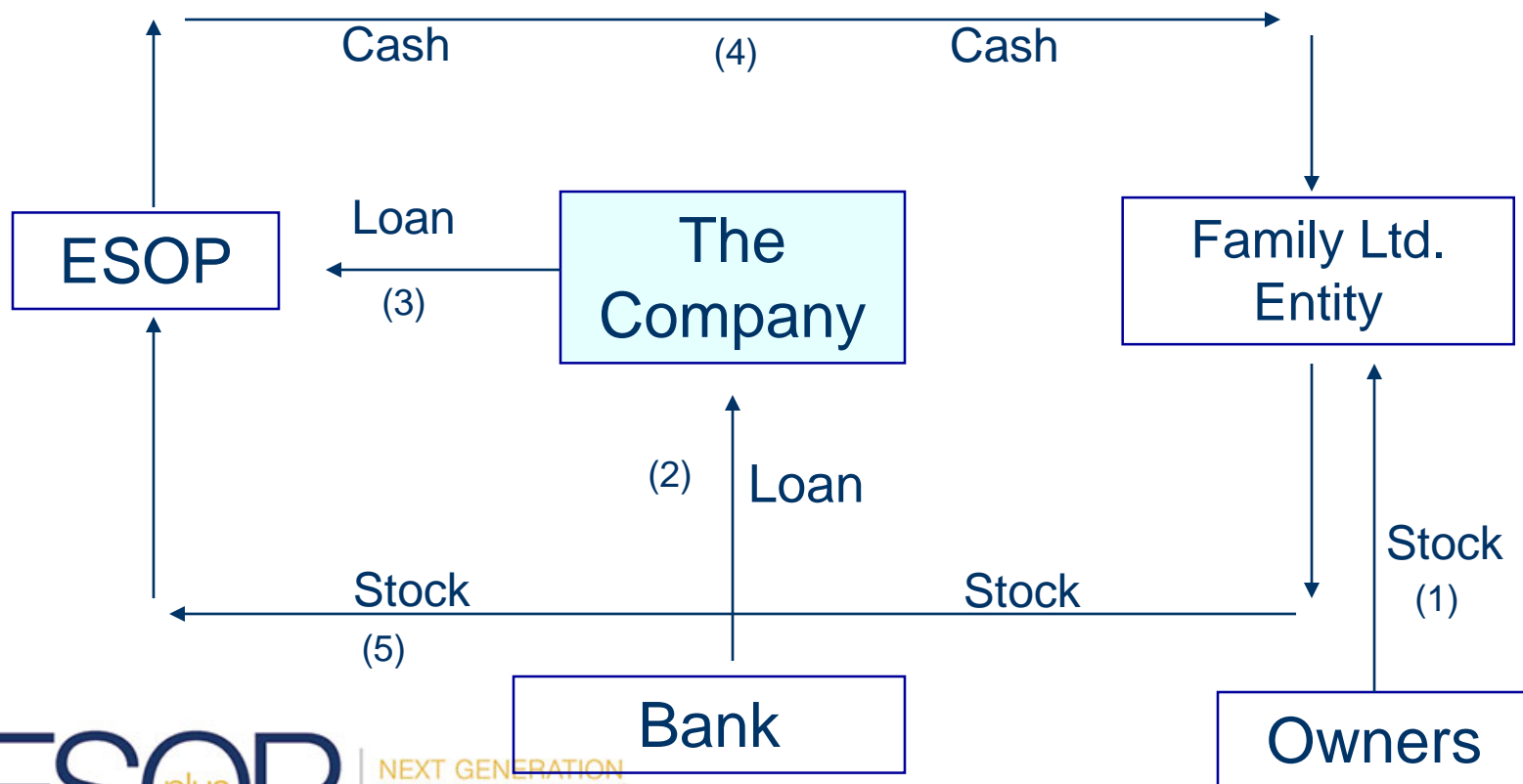
# Legacy Planning

## CHESOP: combination ESOP and CRT



# Legacy Planning

FLESOP: combination ESOP and Family Limited Entity



# Estate Tax Schedule

<u>Year of Death</u>	<u>Exemption Amount</u>	<u>Maximum Rate</u>
2007	\$2,000,000	45%
2008	\$2,000,000	45%
2009	\$3,500,000	45%
2010 default	Unlimited	NA
2010 basis step up	\$5,000,000	35%
2011	\$5,000,000	35%
2012	\$5,120,000	35%
2013	\$5,250,000	40%
2014	\$5,340,000	40%
2015	\$5,430,000	40%
2016	\$5,450,000	40%
2017	\$5,490,000	40%

(double for married couple)



# Gift Tax Schedule

<u>Year of Gift</u>	<u>Lifetime Exemption</u>	<u>Annual Exemption</u>	<u>Maximum Rate</u>
2007	\$1,000,000	\$12,000	45%
2008	\$1,000,000	\$12,000	45%
2009	\$1,000,000	\$13,000	45%
2010	\$1,000,000	\$13,000	35%
2011	\$5,000,000	\$13,000	35%
2012	\$5,120,000	\$13,000	35%
2013	\$5,250,000	\$14,000	40%
2014	\$5,340,000	\$14,000	40%
2015	\$5,430,000	\$14,000	40%
2016	\$5,450,000	\$14,000	40%
2017	\$5,490,000	\$14,000	40%

(double for married couple)



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# Case Study 1: The Perfect ESOP

- Distribution Company
  - Owner/Founder sole shareholder
  - Very profitable with great products
  - Great customer care and great employee care
  - Outside offer considered and rejected
  - Company culture and business legacy important
  - Elected Section 1042 then became S corporation
  - Bank and seller financing
  - Established directed fund at public foundation
  - Created significant business & charitable legacy

# Case Study 2: Family Triangle

- Manufacturing Company
  - Three family factions – equal faction ownership
  - Disagreements on sale of Company & internal transfers
  - ESOP presented as neutral party
  - Each faction agreed to sell majority of faction ownership to ESOP (eventually became 100% ESOP)
  - Each faction represented on Board of Directors with two independent Directors
  - President from the faction remaining active in the Company

# ESOP Next Steps

- Requires investment of time and resources
- Complexity and regulation
- Need experienced advisors
- Must use independent ESOP valuator

**A Feasibility Study Will  
Determine If The Benefits  
Outweigh the Challenges**

# Conclusion and Questions

## Successful Succession Plans Consider

- Management Succession
- Ownership Transfer Methods
- Tax Implications (income, gift, estate, etc.)
- Financial Security of Owners
- Legacy Interests of Owners
- The future of the business

# Plan to be Successful



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# Tim Jochim

- Tim Jochim, Partner, Schatz Brown Glassman LLP
- 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 by Chambers Partners USA. Martindale-Hubbell Rating of AVP. Fellow, American College of Employee Benefits Counsel.

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