Eyes on the Prize

Heading for the Exits: Preparing for the Sale of a Family Business—Part Two

Family squabbles and lack of advanced planning can result in higher-than-necessary taxes for family business owners selling their companies.

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From tumultuous capital markets to estate planning considerations, there is ample cause for family business owners to consider the near-term sale of a majority stake. As noted in “Heading for the Exits: Best Laid Plans,” part one of our two-part research report, a recovering private equity sector could provide a profitable exit for some first-generation companies that exhibit the potential for strong return on investment.

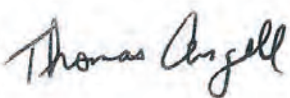
For businesses seeking to differentiate themselves from the competition, the ability to demonstrate a model for growth and a viable brand are imperative. The quality of professional relationships with investment bankers, attorneys and consultants will also be a factor in discussions, as will any aspect that could affect the ease of the transaction. As noted in part two of the Rothstein Kass survey report, “Heading for the Exits: Eyes on the Prize,” the complexity of intra-family relationships can be one of the greatest challenges to the successful sale of a family-owned enterprise. Unfortunately, family disputes have the potential to obscure alignment of interests, cloud decision making and undermine the value of the business.

Our research for “Heading for the Exits” clearly indicates a generational disconnect on the issue of business succession. While many business owners report that they are struggling to find a qualified successor, many proposed sales to outside interests are opposed by family members who believe they should have an opportunity to take up the reins. Many family-owned enterprises may find these conflicts difficult to resolve. Business owners with a longer timeframe for sale can greatly increase the scope of options available by planning now. Our research suggests that in light of the current low interest rate environment and lower enterprise valuations, some business owners may ultimately decide to pursue the transfer of assets to family members.

In addition to the tax benefits, this strategy can often help to establish family legacy while promoting harmony. A key to success will be adopting a unified approach to wealth management. The ability to bridge generational divides through mentorship and education will lead to increased demand for family business advisors.

“Heading for the Exits” draws on the experience and expertise of the Principals in the Commercial Services Group and Family Office Group of Rothstein Kass. We are pleased to share their insights with you and encourage you to contact us to discuss findings.

Thank you for your interest and support.



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Key Themes

- About half of family-owned businesses that are preparing to sell a majority stake expect to do so within a two-year window. The remaining half of businesses are targeting a timeframe of at least two years or longer.
- Almost three-quarters of family-owned entities have not taken any steps to mitigate taxes on the transaction, though impending sales often prompt higher levels of activity among the owners.
- Short-term sales, or those taking place in less than two years' time, are more likely to occur between family members than to outside or unaffiliated entities.
- Most business leaders claim the involvement of another family member would hinder tax planning discussions, so they have avoided doing so in favor of monetizing the business with fewer complications.
- The large majority of family members object to a sale of a family-owned enterprise due to unfair pricing and poor negotiations, which can impact their personal finances and lifestyle.

About the Research

In the first quarter of 2010 we spoke with 382 C-level executives of family-owned enterprises who were actively engaged in conversations with advisors about selling their companies. Each of the companies that participated in the survey met the following criteria:

- A majority stake is controlled by the family
- A family member fills the senior-most position (C-level executive) at the firm (e.g., chairman, chief executive officer, president)
- The generation that established the business continues to manage the business; it has not passed to a second or third generation
- Immediate and extended family members are employed by the company

A Profile of Family-Owned Businesses

Slightly less than half, or 44%, of the firms surveyed said they plan to sell within the next 24 months, while the balance of companies have a slightly longer timeframe and don't plan to take action until at least two years have passed. (Figure 1)

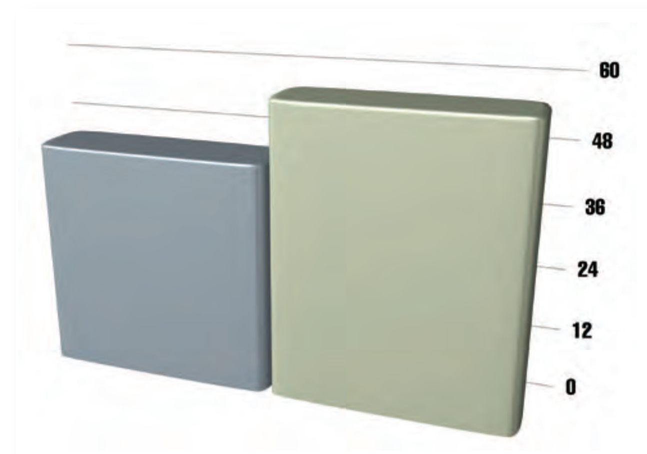

Figure 1: Planning to sell

<2 years 44.2%

2+ years 55.8%

N = 382 Family Businesses

About half of firms reported sales between $30 million and $100 million in the 2009 calendar year. Slightly more than one-third posted sales in excess of $100 million, and the remaining 15% of companies had sales between $10 million and $30 million. (Figure 2) As covered in "Heading for the Exits: Preparing for the Sale of a Family Business **Part One** – Best Laid Plans," while the motivations for selling a family business are varied, liquidity and legacy concerns were nearly universal. (Figure 3)

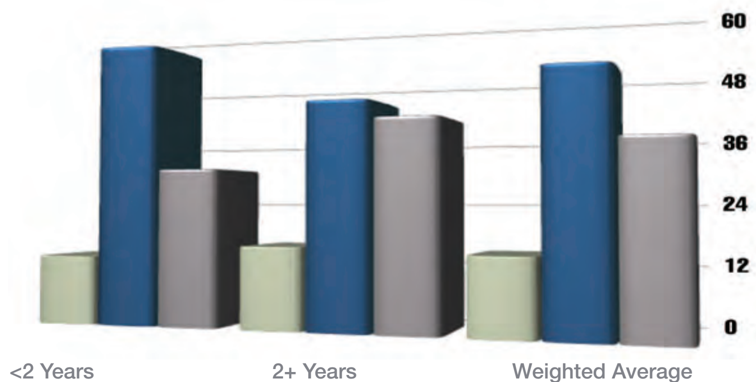

Figure 2: Sales in 2009

	<2 Years	2+ Years	Weighted Average
$10M to $30M	13.6%	16.0%	14.9%
$30M to $100M	55.6%	43.7%	49.0%
More than $100M	30.8%	40.3%	36.1%

N = 382 Family Businesses

Figure 3: Reason to sell	<2 Years	2+ Years	Weighted Average
Want the money that is tied up in the company	96.4%	96.7%	96.6%
No family member is able to take over running the company	89.9%	93.9%	92.1%
Expect to get the best price	62.7%	91.1%	78.5%
No one internal is able to take over running the company	82.2%	73.2%	77.2%
Don't want to work as hard anymore	77.5%	13.6%	41.9%
Want to do something different with his/her life	12.4%	15.5%	14.1%
Want to start a new company	5.3%	21.1%	14.1%

N= 382 Family Businesses

Time Is of the Essence

Despite the stated objective of generating liquidity, roughly three-quarters of firms surveyed have not taken any measures to minimize the tax from a liquidity event. However, when viewed by timeframe for sales, those firms that plan to sell within the next two years were more than twice as likely to have taken steps to manage their tax burden. About 40% of firms that plan to sell within the next two years had taken steps, versus just 16% of those looking beyond the two-year period. (Figure 4)

To get a better feel for why so few firms had taken steps to protect themselves in the event of a sale and retain as much of the proceeds as possible, we probed further. The most common reason for not taking action was the required involvement of another family member; in some cases, the chief executive of the firm had not yet informed the other family members, or employees, about the impending sale and anticipates pushback. In other cases, business leaders expressed concern about a loss of control once others become part of the process.

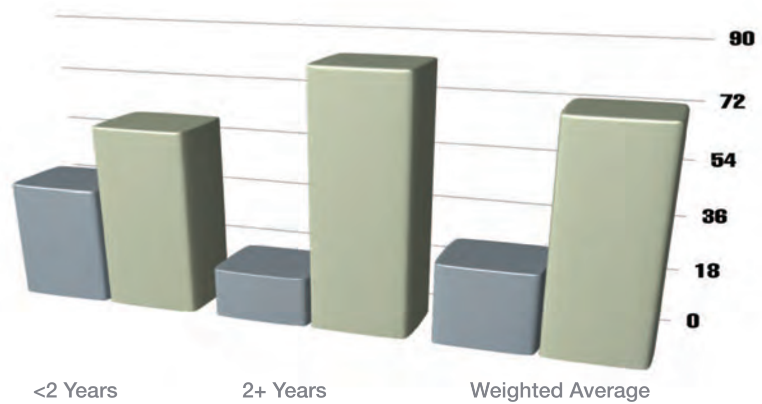

Figure 4: Have taken steps to mitigate taxes from the sale of the company

	<2 Years	2+ Years	Weighted Average
Yes	39.1%	16.4%	26.4%
No	60.9%	83.6%	73.6%

N = 382 Family Businesses

"With all of the reasons reported for deferring advanced tax planning, involving other family members in the process was the most daunting. It is indicative of the ongoing struggle that family businesses face in balancing personal and professional relationships," said Tom Angell, Principal-in-Charge of the Commercial Services Group at Rothstein Kass. "For many of these enterprises, however, sale to family members could result in the best outcome. By bringing family members into the process earlier, business owners can understand divergent objectives and work to align interests. At the same time, current business valuations and a low interest rate environment can make the transfer of business interests to a family member advantageous from a tax perspective."

Figure 5: If no advance tax planning, why not?	<2 Years	2+ Years	Weighted Average
Other family members would have to be involved	35.0%	53.4%	46.6%
No one brought it up	18.4%	11.8%	14.2%
Doing so will just complicate matters	12.6%	12.4%	12.5%
Focused on the sale; not considering other issues	15.5%	5.6%	9.3%
Don't have the time	8.7%	9.0%	8.9%
The advisors didn't press the matter	5.8%	4.5%	5.0%
It's not important	3.9%	3.4%	3.6%

The next most frequently cited reason for the lack of advance tax planning was that no one among the company's employees or its advisors had raised it as a concern. Third on the list was a feeling that such preparations would further complicate an already difficult and lengthy process, and the fourth explanation was that all efforts were being directed toward the transaction to the exclusion of other matters, even if those initiatives could have a substantial financial benefit for the parties involved.

Fewer than 10% of respondents said they had not taken any steps because they didn't have time to research the issue, their advisors hadn't pressed the matter or that tax planning wasn't important. (Figure 5)

The marked differences emerged when the results were viewed by the sales timeframe of the firms surveyed. More than half of the firms with a longer-term outlook have not broached the subject with other family members yet but still have the option to do so as a sale becomes imminent.

Figure 6: Family members opposed to the sale

	<2 Years	2+ Years	Weighted Average
Opposed	76.3%	64.8%	69.9%

Internal Affairs

Not surprisingly, when a family-owned business is large enough to employ several individuals from an extended family unit, it becomes an entity unto itself. When that happens, many people take a proprietary view of the company and its relative importance in their lives. Most family-owned companies are held tightly by the majority shareholders who feel that their standard of living or personal power will slip if the company is sold to non-family members. As evidence, more than two-thirds of family members oppose the sales of their family-owned businesses. (Figure 6)

"The concern that business owners expressed regarding the availability of a qualified successor in part one of our survey suggests that they will frequently seek an outside buyer for the company. Unfortunately, their efforts will often be opposed by other family members who have their own ideas of what is best for the future of the company. Some business owners will confront the unpalatable choice of compelling family members to accept a deal they oppose, or risk the ability to secure the best price," said Rick Flynn, head of Rothstein Kass Family Office Group. "For businesses with a slightly longer time-frame for sale, it is often advisable to partner with professional advisors that specialize in providing consulting services to high-net-worth individuals and families. Multifamily offices, for example, can help an individual to adopt a unified approach to succession, estate and tax planning to alleviate concerns of other family members regarding a possible sale."

Figure 7: If opposed, reason opposed	<2 Years	2+ Years	Weighted Average
Concerned that they won't get a fair price	88.4%	86.2%	87.3%
Believe certain family members should have the opportunity to run the company	70.5%	52.2%	61.0%
Expect the company to grow substantially	36.4%	73.9%	55.8%
Opposed to selling the family legacy	37.2%	16.7%	26.6%

When the sale is imminent, most stakeholders are concerned they won't get a fair price or that other relatives haven't been given a chance to assume control of the business due to the haste of the transaction. When segmented by the proposed timeframe for sale, a much larger percentage of family members from companies that plan to sell at least two years in the future expects significant long-term growth that might be unrealized if a sale is pursued in the near term. Very few family members in total objected to a sale on the grounds of familial tradition, which is not surprising given that all the firms were still run by the founding generation. (Figure 7)

"The legacy concerns of first-generation businesses are dwarfed by the desire to get a fair price. It is also interesting to note that a fairly large percentage of respondents believes that other family members should get a chance to manage the business. In a low interest rate environment, some business owners faced with depressed asset valuations will consider transferring shares to heirs. Utilizing tax-efficient structures, individuals can create a steady income stream while maximizing the value of the transferred asset for future generations," said Neil Tendler, a Principal at Rothstein Kass.

Among the firms that have taken steps to manage the tax consequences of a sale, the actions were markedly different depending on their timeframe for selling. Firms that plan to sell within a 24-month period were most likely to transfer the shares to another family member, thereby mitigating certain tax consequences, with about two-thirds of respondents citing this as their strategy.

Figure 8: Steps taken to mitigate tax consequences of a sale	<2 Years	2+ Years	Weighted Average
Transferring shares in the company to family members	66.7%	17.1%	49.5%
Using legal structures to discount the value of the company	27.3%	31.4%	28.7%
Freezing the value of the company for estate tax purposes	19.7%	37.1%	25.7%
Using a charitable remainder trust	9.1%	28.6%	15.8%
Maximizing basis planning	3.0%	8.6%	5.0%

"Transferring shares to family members has been the most frequently employed strategy among businesses seeking to mitigate the gift tax consequences of a sale. As some business owners explore the sales process more thoroughly, they may discover that the tax advantages of transferring a controlling stake to a family member over time are too compelling to ignore," said Mr. Flynn. "The reality is, because of economic conditions and family concerns, more first-generation businesses are likely to become multi-generational enterprises than even their owners are anticipating. These entities will fuel the continued growth of the multifamily office sector as business owners seek advisors with the ability to facilitate and manage professional relationships with investment bankers, attorneys and accountants while considering the economic, tax and emotional impacts of an eventual sale."

About one-quarter of firms were utilizing legal structures to discount the value of the company, and about one in five were freezing the value of the business for estate planning purposes. Less than 10% of those surveyed were using charitable remainder trusts or maximizing their tax basis planning.

"Valuation discounts, such as the marketability discount for non-public entities and the minority discount for the transfer of a non-ownership stake, are under-utilized tools that can greatly enhance the value of the transferred asset for future generations while minimizing the estate and gift tax consequences for the business owner. Whether an owner is anticipating a sale to family members or outside interests, it is important to understand the full range of options," said Mr. Angell.

The results were different for those firms that plan to sell at least two years out. Almost 40% were freezing the value of the firm, about one-third were using various legal structures to discount the business valuation, and a little more than one-quarter were using charitable remainder trusts. Less than 20% have plans to keep the company stock within the family, and less than 10% have sufficiently maximized their cost basis planning. (Figure 8)

Case study: Intentionally defective grantor trust

Father (F), Mother (M), Son (S) and Daughter (D) owned Ship Repair, LLC (Ship) as follows: F – 1%, M – 97%, S – 1% and D – 1%. The undiscounted fair market value of Ship was approximately $100 million. Ship has been in business for over 50 years and is now owned by the second generation of the family. F and M are in their 60s and are managing members of Ship but do not participate in the day to day management of the entity. S has limited involvement with Ship currently but will represent the family upon the demise of F and M. D is not involved with Ship.

M wanted to transfer some of her interest in Ship to S and D as part of Ship's overall succession plan while retaining some of the cash flow generated by the interests that were to be transferred to S and D.

Accordingly, it was recommended that M sell 25% of her interests in Ship to a newly created Family Trust, an intentionally defective grantor trust (IDGT) in exchange for a Note. The principal balance of the Note was $16,975,000, computed as follows: $100,000,000 X 97% ownership X 25% (amount transferred) X 70% (accounting for a 30% discount). The sales price incorporated a 30% discount determined by an independent appraiser due to the lack of marketability and lack of control associated with the interest that was sold. The Note was a nine-year Note that required payment of interest only ($432,863) during its term, with a balloon payment ($16,975,000) at the end of the term. The interest rate in the Note was the mid-term applicable federal rate (2.55%) for the month and year that the Note was executed. In addition, M gifted $1,887,000 to the Family Trust at its inception to provide the trust with substance and the initial wherewithal to make the interest payments.

The beneficiaries of the Family Trust were S and D as well as their potential issue. M and F allocated their generation skipping transfer tax exemption to the Family Trust, ensuring that the trust would be exempt from potential generation skipping transfer taxes.

M does not have to recognize any taxable income from the sale of her 25% interest to the Family Trust since the trust is a grantor trust. In addition, M does not pay tax on the interest income that she receives, nor does the Family Trust deduct the interest that it pays. M is required to pay income tax on any taxable income that is realized by the Family Trust which is actually a benefit and can be viewed as a tax-free gift. If M dies while the Note is outstanding, the Note is includible in her taxable estate, and there is currently uncertainty whether or not the death would trigger a capital gain. Finally, in this situation, even though M has made a taxable gift of $1,887,000, M and F elected to split their gifts, and each had their $1,000,000 lifetime exemption remaining so they did not incur any gift tax liability as a result of this transaction.

If Ship continues to appreciate at a rate of 8% per year through the end of the Note term, M would have transferred approximately $29 million of assets to the Family Trust for the benefit of her heirs without paying any transfer taxes, computed as follows:

Year	Beginning Undiscounted Fair Market Value of Trust	Appreciation	Interest and Principal Payments	Ending Undiscounted Fair Market Value of Trust
1	26,137,000	2,090,960	432,863	27,795,098
2	27,795,098	2,223,608	432,863	29,585,843
3	29,585,843	2,366,867	432,863	31,519,848
4	31,519,848	2,521,588	432,863	33,608,573
5	33,608,573	2,688,686	432,863	35,864,396
6	35,864,396	2,869,152	432,863	38,300,686
7	38,300,686	3,064,055	432,863	40,931,878
8	40,931,878	3,274,550	432,863	43,773,566
9	43,773,566	3,501,885	17,407,863	29,867,588

Case study: Strategy to transfer shares to family members

XYZ Corporation's sole shareholder had always assumed that his three children would one day join him in – and eventually run – the family business. As such, he transferred equal amounts of shares in his corporation to his three children, all of whom were under the age of 18, and equal shares were to continue to be gifted over time at discounted values. However, when one by one the children graduated from college, it became apparent that only one of the three would enter the business, so a new strategy was warranted.

The father was committed to treating each of his three children fairly, regardless of each child's decision to join – or not join – the business, but he was undecided as to whether he should (1) leave the current three-shareholder sibling ownership structure in place or (2) have the sole employee-child buy the shares from the two non-employee children and compensate the non-employee children for the disparity of future assets, in this case, ownership of the business.

After consulting with advisors, the father decided that it would be best for the long-term health of the business and the family if the employee-child had full control of the business after the father retired. This would mean that the non-employee children would have to sell their existing shares to the employee-child and that future shares slated for the non-employee children would from that point forward go only to the employee-child shareholder.

Advisors brought in an independent third-party valuation specialist to perform a valuation on the non-employee children's minority interest. Based upon that price, an agreement was entered into for the non-employee children to sell their shares to their employee-sibling. The notes were for five years, using the applicable federal interest rate. The employee-child shareholder increased her compensation in order to be able to pay the monthly note payments to her siblings. Upon retirement, the father would sell his remaining interest in the corporation to his employee-child and compensate his other children by allocating to them other assets in his estate.

About the Authors

Russ Alan Prince is the world's leading authority on private wealth, the author of more than three dozen books on the topic, and a highly-sought counselor to families with significant global resources, and their advisors. He is co-author of *Inside the Family Office: Managing the Fortunes of the Exceptionally Wealthy.*

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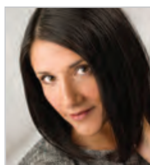

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About Rothstein Kass

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