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Business Succession Planning Case Study
Part I of II

In a recent case, we had an elderly client ("Father" or "Client") who, together with his son ("Son"), owned shares in a "small" (approximately $15,000,000) corporation engaged in the manufacture of high tech pharmaceutical devices. The corporation is an S Corporation for federal tax purposes.

Like his Father, Son was actively involved in the business. Unfortunately, Son was diagnosed with Lou Gehrig's Disease. Client's other children, however, were not involved in nor did they have any background or even any interest in the business. Due to Son's illness, he was not a potential candidate to take over the business. There was, however, a high level employee ("Employee") at the company with significant work experience, and an entrepreneurial bent, who was interested in obtaining an ownership stake in the business. Because this well-placed employee was fairly young, he did not have sufficient resources to purchase the client's stock in a lump sum.

Client had multiple objectives, including the following: (1) he wanted to provide long-term "asset protection" planning for his children and their families for multiple generations by avoiding complications associated with a child's divorce, disability, or substance abuse; (2) he wanted to arrange an orderly succession with respect to the business; (3) he wanted to maintain ongoing control of the company during the period that the business was being transferred to a third party; (4) he wanted to fully utilize both his own and his spouse's exemptions from federal gift tax ($5,000,000 each during 2011 and 2012 only); (5) he wanted to protect the corporation's ability to qualify as an S Corporation for federal income tax purposes and, (6) he wanted to engage in the most tax efficient planning possible.

We helped Client meet all of his goals through the adoption of a combination of business succession planning, asset protection planning, and efficient tax planning techniques. The Client made it clear that the success of the business and the non-taxed benefits were most important to him. As we discussed during our various meetings, the tax benefits, although important, would be irrelevant to the Client if the business failed or the non-tax benefits of the plan were not achieved. Those techniques included the following:

- **First,** we recapitalized the corporation's capital structure to provide for the issuance of both voting and non-voting common stock shares. (Father held most of the corporation's stock and he therefore, received most of the voting and non-voting stock shares in the recapitalized entity.)

- **Second**, Father contributed all of his non-voting shares (and a significant minority of his voting shares) in the company to a special type of trust (known to tax practitioners as an “intentionally defective grantor trust”) created primarily for the benefit of Son, and the other children in his family.

- **Third**, Client (Father) and his wife elected to “split” the gift for tax purposes (i.e., treat all gifts by either of them as having been made 1/2 by each of them), thereby enabling them to maximize their exclusions (up to $5,000,000 each) from federal gift tax.

- **Fourth**, the Corporation’s shareholders (Father, Son and the trust) engaged in negotiations with the Employee for the purchase of non-voting stock. The Employee was represented by his own attorney and a strategic business planner. The overall plan was called into question by Employee’s attorney and business planner, and the purchase price was intensely negotiated. One important issue that needed to be addressed was the value of the company with and without the Employee. Employee’s attorney and business planner presumed that Employee was paying for his own value.

Also called into question and intensely negotiated was retention of control by the Father and the period at which the Employee would have the opportunity to purchase voting control of the company.

After substantial negotiations relative to the purchase price, a compromise was reached. Employee purchased the non-voting stock from the trust while Father retained a controlling interest in the corporation until the earlier to occur of (1) the Employee satisfying the installment notes for purchase of stock in full; or (2) the Employee paying down the principle balance of the notes in excess of 60% of the original principle balance and the creditors of the corporation removing the Father as guarantor on loans made to the corporation.

Although neither party got exactly what they wanted in the transaction, it worked out well for both the Client and the Employee. The resolution of the issues most contested during the negotiations, and the compromises made, helped provide an important foundation for the success of the plan.

NOTE: In this case, the trust had a number of features that made it particularly attractive to the Client: (1) the trust term was indefinite, thereby benefitting Client’s children and their families potentially over several generations; (2) under the terms of the trust agreement, trust assets will never be part of a child’s marital estate and thus never subject to equitable division upon divorce and will not be subject to any other creditors of the beneficiaries; and (3) the trust was, for federal tax purposes, treated as a “look-through” entity, thereby making it possible for the corporation to continue to qualify as an “5” Corporation for federal tax purposes (ordinarily a concern when an entity owns stock in an “5” Corporation).