

The ABCs of Ownership Succession

What will happen to your life's work when you no longer run your business? How will those you care about be impacted by the decisions you make (or don't) today? Advance planning for the future of your business is the surest way to see your vision continue, while also meeting the needs of your company, employees and family for years to come. Read on for insight and actionable ideas about the succession planning process and relevant strategies, based on a series of presentations by Bank of America Merrill Lynch experts at our nationwide 2010 Business Forums focused on helping businesses thrive in a challenging economy.

Plan ahead and take a holistic view.

Ownership succession creates a range of personal and business considerations. Planning for the transfer of ownership requires a complete view of both sides, and the ability to thoughtfully and objectively consider the right approaches. When the time comes to transition ownership or management, it may be sudden due to death or incapacity, or right on schedule but in an environment and a timeframe that is less than ideal to make clear, informed decisions.

The best succession planning strategies are developed over time with the expertise and guidance of experienced professionals. Beyond your business attorney, you may consider consulting with an experienced income tax attorney or certified public accountant, an estate planning attorney and, in some cases, a family psychologist, all of whom can assist you in creating a holistic succession plan.

PERSONAL PLANNING

Determine if and when you will want to sell.

The factors that drive your decision to sell your business during your lifetime typically vary by generation. Original owners often find it difficult to let go of control and to step aside at the right time. Looking to the second generation for potential successors is often clouded by sibling rivalry. If some of your children have been active in the business while others have not, you must decide whether to divide the estate equally, and if so, how to leave the business to the participating child if it's your most substantial asset. Likewise, third generations in a long-standing family business often include competing cousins or grandchildren who have varying levels of engagement in the business.

Older generations are typically more motivated to retain ownership for a variety of reasons, but ultimately the decision will depend on whether you can afford to

Bank of America Merrill Lynch Contributors

Kalyani Chirra

Wealth Strategies Advisor
U.S. Trust

Pam Ellison

Private Client Advisor
U.S. Trust

Neal Hawkins

Credit Products Officer
Global Commercial
Banking

Larry Macklin

Wealth Strategies Advisor
U.S. Trust

Lynne L. Pantalena

Wealth Planning
Solutions Central Division
Executive
U.S. Trust

Susan Peterson

Wealth Strategies Advisor
U.S. Trust

James Teichman

Credit Products Officer
Global Commercial
Banking

transfer ownership. If your children cannot afford to pay a reasonable price, selling to them can significantly impact your retirement plans. You must also consider whether your children are capable of effectively running the business and what impact their decisions would have on your investment. If you have a strong desire to keep the business in the family, it's critical to determine who will be best equipped to lead the company forward.

Consider the income tax implications.

There are several income tax-related factors to consider if you plan to sell your business. For example, businesses organized as a C corporation are subject to double taxation, both on the income of the entity as well as the dividends distributed to individual shareholders. In an S corporation, partnership or another flow-through entity, the

company's income or losses are passed through to its shareholders, who must report them on their individual income tax returns.

In a continually changing tax environment, it's also important to anticipate future tax rates. If you're selling the business and have the option of receiving a single payment or installments, understanding the tax rates in each year becomes key. In 2010, the highest Federal marginal tax rate is 35%, and is currently scheduled to increase to 39.6% in 2011. Likewise, the capital gains rate is scheduled to increase from 15% to 20% year-over-year. Beginning in 2013, there is an additional 3.8% tax on investment income for high income individuals, including capital gains, subject to any future changes in Congress.

Use gift and estate tax exemptions to your advantage.

In 2010 we experienced a rare reprieve from estate tax and generation-skipping tax. Barring future tax law changes, a more typical environment will resume in 2011 in which each person will have an estate tax exclusion amount of \$1 million. Assets over \$1 million will be subject to a 55% estate tax.

When it comes to gifting, each individual has a \$1 million lifetime gift tax exemption. This means that you can transfer up to \$1 million in assets in aggregate over your lifetime, reducing your estate tax exclusion amount.

For instance, if an individual makes a million dollar gift and then dies in 2011, they would have no estate tax exclusion.

A key transfer tax exemption is the unlimited marital deduction between spouses during their lifetime or upon death. Another is the annual gift tax exclusion amount of \$13,000 that can be made to any number of recipients and does not count toward the lifetime \$1 million gift tax exemption. Transfers to charity and certain qualified medical and educational expenses are among additional

transfer tax exemptions. To be most effective, gifts should be assets with high appreciation potential and with a high income tax basis, leaving low-basis assets to receive a step-up in basis upon death.

Address estate planning in three key phases.

Looking at your overall estate picture, it helps to plan in three primary phases: core, liquidity and estate tax reduction.

Core planning

The nucleus of your plan centers on your dispositive wishes and available tax exemptions. This includes establishing wills, revocable living trusts, durable powers of attorney and related documents, plus wealth protection planning for your surviving spouse and children. Your core asset plan should ensure your assets will be distributed to your intended beneficiaries in the manner you choose, whether immediately or through a trust arrangement, and in a tax efficient way.

You will name the person(s) you want to manage the process for your beneficiaries. In the event you become incapacitated, your core planning documents will name an agent you wish to sign documents and manage all your personal side assets (assets outside of your revocable living trust) on your behalf. On the business side, you should also have documents in place determining who will step in should you no longer be able to carry out your responsibilities.

Liquidity planning

Once you've established your core estate planning documents, it's important to consider cash flow and the liquidity that will be required to pay your projected estate tax and support surviving family members who are dependent on your salary. If your assets are tied up in the company, is there a mechanism in place to take sufficient liquidity out of the business? Will your children have the funds to continue the business and pay the 55% estate

Year	Estate tax applicable exclusion amount	Lifetime gift tax exemption	Generation-skipping transfer tax exemption	Maximum estate, gift and GST tax rate
2009	\$3,500,000	\$1,000	\$3,500,000	45%
2010	Not applicable	\$1,000	Tax repealed	35% (gift tax only)
2011 and after	\$1,000	\$1,000	\$1,000 (adjusted for cost-of-living)	55%

tax that is scheduled to resume in 2011? If cash flow is a concern, do you have adequate life insurance to help provide for your dependants? Building in a buyout provision and considering insurance options are important ways to address future liquidity needs.

Estate tax reduction planning

The third critical stage in the estate planning process focuses on reducing estate taxes. While there are a number of complex strategies you can consider that will transfer interest to your children while reducing some or all of the gift tax liabilities, most typically fall under five general categories: annual gifting, discounting techniques, split interest gifts, freezing techniques and charitable planning.

- **Annual gifting:** Referenced previously, there is an annual gift tax exclusion of \$13,000 that can be made to any number of recipients and does not count toward the lifetime \$1 million gift tax exemption. Consider, for example, if you are starting a new business with a zero value and you make a \$13,000 gift to each of your children while also establishing them as 50% owners. When you sell or experience future appreciation, 50% of the value of the business will benefit your children and will not be counted as part of your taxable estate.
- **Discounting:** Recapitalizing an S corporation or establishing a family limited partnership LLC are the most common discounting techniques. For instance, if you have an S corporation with all voting stock, you could recapitalize to establish one share of voting stock and 99 shares of non-voting stock. Gifting the non-voting stock to your children enables them to take a discount for lack of control over the business. Likewise, if it's a closely held corporation, they can also receive a discount for lack of marketability because the stock cannot easily be sold on the open market. Combining those two discounts, you could generate a tax savings on the assets of 15% or substantially more, depending on the situation.
- **Split interest gifts:** A grantor retained annuity trust (GRAT) is a common strategy that allows you to transfer all appreciation above the IRS discount rate to your children without any transfer taxes.
- **Freezing:** An installment sale to an intentionally defective grantor trust (IDGT) is among the techniques that enable you to freeze the current value of your business and transfer all future appreciation to your beneficiaries.
- **Charitable planning:** There are numerous charitable planning strategies you can consider, preferably with a financial advisor specializing in this area. A charitable remainder trust (CRT) is an income tax planning tool that can provide estate tax benefits, while a charitable lead

Buy/Sell Agreements

If you co-own your business, it's important to have a written agreement that addresses what happens if one of the co-owners is disabled, divorced, experiences creditor default, retires or dies. Buy/sell agreements generally fall into two types: stock redemption (the company buys the shareholder's stock in the event of divorce or other trigger) and cross purchase (shareholder-to-shareholder stock purchase). You may implement both types of arrangements within the same agreement, such as giving the company first right of refusal to buy out that interest, followed by the shareholders. The agreement will specify the trigger events as well as the process by which to determine the purchase price.

trust (CLT) is an estate tax planning tool with income tax benefits. Other strategies include establishing private foundations, supporting organizations and donor advised funds.

BUSINESS PLANNING

Assess your five key business dynamics.

In addition to personal planning described above, as a business owner there are generally five types of dynamics you must consider when planning a succession and liquidity event:

- **Ownership dynamics:** How many owners are involved and what are their individual timelines for stepping down and seeking liquidity?
- **Liquidity and diversification:** As an owner, are you looking to maximize price or minimize taxes?
- **Company dynamics:** Is your company in a growth industry or more mature environment? Are there competitors who may be positioned to buy you out?
- **Management and employee succession:** Do you have a management team in place that can effectively lead your business forward when you retire?
- **Timing/risk:** How might the capital markets and banking markets impact your sale price within your projected succession timeframe?

Evaluate liquidity and ownership transition alternatives.

In addition to continually assessing working capital needs, cash flow and liquidity investing strategies, you must also consider how future ownership succession will impact your capital structure and the future of your

business. Following are summaries of six options you should consider well in advance of a potential transfer of ownership in order to achieve maximum value and the right terms and conditions for you and your company.

Leveraged recapitalization

If you seek to retain full control while providing immediate partial liquidity to shareholders, a leveraged recapitalization provides a dividend funded with bank and possibly mezzanine debt. You retain 100% equity without transferring any of the wealth or management decisions, but also retain full equity risk. Be sure to consider whether the amount of liquidity available is sufficient and whether the additional debt may negatively impact the business.

Management buyout

Provided you have others in the company with the ability and desire to take over, your management team could acquire the business from shareholders with a combination of bank debt, mezzanine debt, seller notes and equity. This provides some immediate liquidity as well as management continuity, and increases the certainty of completing the transaction given the existing relationships and knowledge of the company. A significant consideration is whether the management team has the equity or financial wherewithal to purchase the company at the price and terms that you seek.

Employee stock ownership plan (ESOP)

An ESOP is a qualified retirement plan that can be used to gradually transfer ownership of your business to your employees, either through a majority or minority sale. Your employees gain equity over time while you and your company gain tax benefits. 100% ESOP-owned companies with S-Corp structures are exempt from Federal income tax liability and may have greater borrowing capacity due to tax advantaged cash flow. Note that the cash available to shareholder(s) upon ownership succession is limited to the company's debt capacity. In addition, the business is obligated to perform annual ESOP share valuation as well as to repurchase ESOP shares as people leave the company due to retirement, death, termination or resignation.

Recapitalization with a financial investor

Another ownership succession alternative involves the sale of a majority interest in the company to a private equity group. Most private equity investors prefer a majority transaction, but some will consider a minority stake. Advantages include access to a large amount of liquidity for the owners with reduced shareholder equity risk. Shareholders and the management team typically maintain a meaningful equity stake and a similar management role, but lose voting control of the company. The private equity firm will have final decision-making power driven largely by its investment timeline and objectives.

Sale to a strategic acquirer

Selling to a competitor usually provides maximum liquidity and price due to synergistic costs. In many cases, the competitor may be willing to pay a premium to expand their operations with the products, customers or know-how your business has to offer. At the same time, this may cause more disruption to your company's operations and employees than other alternatives, including the elimination of jobs, changes to product lines and other decisions that may not align with your vision.

Initial public offering (IPO)

Tapping the public markets through an IPO is another alternative that provides access to some immediate liquidity or the option to reduce debt. Having access to the equity capital markets also provides flexibility to fund future growth opportunities and acquisitions with fewer covenants and rules than debt financing or private equity.

The offering timeline and results are contingent on equity market activity, however, and there are additional costs of financial reporting and other requirements of the Sarbanes-Oxley act. In addition, management decisions are subject to the scrutiny and approval of public shareholders.

Take advantage of advanced succession planning.

The steps you take now to address the personal and business implications of ownership succession can impact you, your business and your beneficiaries well into the future. For more insight, or to discuss specific ownership succession strategies or other financial needs, please contact your Bank of America Merrill Lynch representative.

"Bank of America Merrill Lynch" is the marketing name for the global banking and global markets businesses of Bank of America Corporation. Lending, derivatives, and other commercial banking activities are performed globally by banking affiliates of Bank of America Corporation, including Bank of America, N.A., member FDIC. Securities, strategic advisory, and other investment banking activities are performed globally by investment banking affiliates of Bank of America Corporation ("Investment Banking Affiliates"), including, in the United States, Merrill Lynch, Pierce, Fenner & Smith Incorporated, which are both registered broker-dealers and members of FINRA and SIPC, and, in other jurisdictions, locally registered entities. Investment products offered by Investment Banking Affiliates: Are Not FDIC Insured * May Lose Value * Are Not Bank Guaranteed. ©2010 Bank of America Corporation.