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ALL IN THE FAMILY

This case study is about a family-owned business located in a small town. The Company is owned and run by a husband and wife who are in their early 60's, with the help of their son. Their daughter lives in another city and has no interest in being involved in the Company.

We were referred to this Company by their investment advisor. We had structured an ESOP for the investment advisor's firm and he was so pleased with the results that he introduced us to several of his clients.

The owners of this Company had these objectives:

- They wanted to ensure that they would be financially secure when they retired. The Company was valued at $10 million. They had accumulated $3 million in investable assets outside the Company and their investment advisor told them that if they could get $5 million out of their Company, they would be able to live off the investment income generated by their $8 million portfolio.
- They wanted to structure their estate plan so that each child would receive 50% of their estate. However, they didn't want their daughter to get any of the Company stock since she wasn't active in the business.
- They wanted to minimize the impact of taxes on their financial and estate planning.

I have found that when working with family-owned businesses, one of their greatest challenges is what is referred to as "estate equalization." Parents generally want to leave equal portions of their estate to each of their children. However, this can be difficult to accomplish when the value of the business is the estate's largest asset and when you have children who are active in the business and children who are inactive. For example, in this case if the parents left the active son the business ($10 million) and the inactive daughter their investment portfolio ($3 million), the children would not be treated equally.

It is almost never a good idea to leave company stock to inactive children since this generally creates a conflict. ("He hit me first…") The inactive children want cash distributions from the business despite the fact that they don't work there. The active children want to be paid the maximum amount possible for their efforts and want to leave some cash in the business for future capital expenditures. This conflict of interests often results in family strife.

An ESOP can help solve this problem. Here is how it helped solve it in this particular case.

The parents sold 51% of their stock to the ESOP for $5.1 million. Since their Company was a C corporation, they were able to invest their ESOP sales proceeds in "qualified replacement property" (QRP) without paying tax on the proceeds. They turned the management of this money over to their investment advisor who created a portfolio of high grade corporate bonds which qualified as QRP (see Chapter 10, Q&As 10-26). The income generated by this bond portfolio plus the income generated by their other assets produced a nice retirement income.

At their death, their inactive child will receive the $5.1 million bond portfolio. She will be able to liquidate the portfolio without paying income tax due to the step-up in basis rules (see Chapter 10, Q&A 4). Immediately after the ESOP was implemented, the parents gifted their 49% interest in the Company to their son. However, the value of this gift for gift tax purposes was substantially less than what you might expect, as explained below.

If the Company is worth $10 million and the parents sell 51% of their stock to the ESOP for $5.1 million, you might well assume that the stock they've retained would be valued at $4.9 million. While that seems logical, the result actually is much better from a gift tax valuation perspective, which will result in substantial gift tax savings.

Prior to the ESOP, the value of the Company was $10 million. This represents the value of the Company's equity, net of its debt. For example, if the value of the Company was $12 million and it had $2 million in debt, the net value of the Company for purposes of a sale would be $10 million.

As a result of the ESOP transaction, the Company had taken on $5.1 million of new debt used to finance the ESOP's stock purchase. This reduced the net value of the Company from $10 million (pre-ESOP) to $4.9 million (post-ESOP). This results in the parents' 49% interest being valued at $2.4 million net of the debt (49% of $4.9 million).

The other valuation consideration that comes into play is the "minority interest discount" (see Chapter 12, Q&As 10-14). The concept behind the minority interest discount is that a controlling interest is worth more than a non-controlling interest. If I own a controlling interest in a company, I can make most corporate decisions without the approval of the non-controlling owners. Therefore, 51% of a $10 million company is worth $5.1 million and 49% is worth less than $4.9 million. In general, minority interest discounts range from 20-40%. In this case we've assumed a minority interest discount of 20% which will result in a gift of 49% of this Company's stock having a gift tax value of $1.92 million ($2.4 million – 20% minority interest discount).

The chart below shows the gift tax valuation concepts involved in this strategy.

49% of Company without ESOP Debt	$4.9 million
49% of Company after ESOP Debt	$2.4 million
Gift of a non-controlling 49% Interest (20% minority interest discount)	$1.92 million

We discussed with this client the potential of the parents making the stock gift to a family limited partnership rather than making it directly to their active child. This could have produced additional valuation discounts for “lack of marketability” (see Chapter 12, Q&A 15). However, this client decided that the elimination of tax on their sales proceeds (via 1042 QRP investments) and the 60% gift tax valuation reduction produced adequate tax savings.

There were two interesting planning challenges involved in this case.

Challenge 1: The first challenge had to do with the requirements of the Section 1042 tax-favored treatment of the sales proceeds. One of the rules involved with Section 1042 is referred to as the “Prohibited Allocation” rule (see Chapter 10, Q&As 27-31). This rule prohibited the active son from participating in the ESOP. As a result, he would not have an ESOP account.

We dealt with this planning challenge by having the Company create a Stock Appreciation Rights plan (SAR) for the active son. Under this Plan, the son would receive contributions to a deferred compensation plan account equal to the value of the stock that would have been contributed to his ESOP account. The value of this account will grow at the same rate that the ESOP shares grow. As a result, the son will receive the same value he would have received under the ESOP. Problem solved.

Challenge 2: The second challenge had to do with the need to sell 51% of the stock to the ESOP in order to take advantage of the minority interest discount when the parents gave their remaining stock to the active son. Often in planning with family-owned companies, the parents want to insure that their child(ren) will have a controlling interest in the company.

This challenge will be resolved as a result of the passage of time. As ESOP participants become entitled to distributions as a result of their death, disability or retirement, the Company will purchase the shares in their ESOP accounts. In relatively short order, this process will result in the son’s shares constituting a majority of the outstanding shares as explained below.

Here's how it all looks in reality. Assume that the parents owned 1,000 shares (100%) of the Company's stock. They sell 51% (510 shares) to the ESOP. They gift their remaining 490 shares to the son.

During the first few years of the ESOP's existence, several employee participants quit. The Company purchases the vested shares from their account, cash is distributed to participants and stock purchased by the Company is retired. Assuming that 30 shares are purchased by the Company through this process (known as a stock redemption), there will be 970 shares outstanding. The 30 shares that were redeemed will be retired as treasury stock. Now that there are 970 shares outstanding, the Company's ownership breakdown is as follows.

ESOP	480 shares (49%)
Son	490 shares (51%)

As a result of this redemption/distribution process, the son will own a majority of the stock in a very short period of time. Over the next 20 years, the son could end-up owning 80-plus percent of the Company through this process.

As can be seen, ESOPs can work well in family-owned companies and can help solve some of the challenges that often exist in planning for their succession.