

Wealth Transfer and Shareholder Agreements: Terms, Tricks and Traps

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Entrepreneurship
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STEVENS & LEE
LAWYERS & CONSULTANTS

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- Co-Chair of Stevens & Lee's Estates and Trusts Department
- Concentrates his practice in estate and trust planning and administration, wealth preservation, trust and estate litigation, charitable and nonprofit organizations, and guardianship administration
- Experienced in advising high net worth clients in all aspects of estate planning, including business succession planning, charitable trusts and other charitable giving techniques
- Has substantial experience in fiduciary litigation, including will and trust contests, abuse of power of attorney matters, and representation of corporate and other fiduciaries in surcharge actions
- Serves as general counsel for a number of charitable organizations, and represents many others as special counsel, advising them about charitable trust law, nonprofit corporate matters and federal tax law and regulations concerning exempt, charitable organizations
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- Shareholder- Stevens & Lee's Corporate, Finance and Capital Markets Group
- Focuses his practice principally on consulting with and advising owners and senior decision makers at privately owned businesses with respect to structuring, negotiating and completing merger and acquisition transactions, joint ventures and other strategic transactions
- Over 20 years' experience representing buyers and sellers in connection with merger and acquisition transactions in a variety of industries, including insurance, wholesale beer distributors, wireless communications and manufacturing
- Represents clients in connection with debt and equity financing and other commercial and corporate law matters, including the preparation and negotiation of Shareholder Buy/Sell and similar agreements for corporations and other business entities
- Temple University School of Law, J.D., and Valdosta State University, B.A., Economics

Proper Planning is Critical

- Involve Key Advisors
 - Legal (Estate Planning and Corporate Counsel)
 - Accountants
 - Insurance
 - Others (?)
- There are upfront costs associated with this process
- However, proper planning and documentation will avoid costly (Time and \$\$) mistakes later
- This presentation is oriented toward a corporation, but issues are equally applicable to limited liability companies and other entities. Manner of documentation may vary.

Tax Basics

- Transfers during lifetime or at death in excess of exclusions will be subject to 40% federal gift or estate
 - \$15,000 per beneficiary annual exclusion
 - \$11,580,000 lifetime (2020)
 - \$23,160,000 total for married couple
 - Lifetime exclusion will revert to about \$6 – \$6.5 million in 2026
 - \$12 – \$13 million for married couple
- Transfers that “skip” a generation are subject to second 40% tax (the “Generation Skipping Transfer” or “GST” tax)
 - Similar exclusions apply
- 4.5% – 15% Pennsylvania Inheritance Tax

Liquidity and Other Issues at Death

- If business is your most substantial asset will estate have sufficient cash to pay death taxes?
- Will liquid assets and/or income from business be sufficient to support family?
- Who will run business pending sale or ascendency of next generation?
- How will your estate retain key employees/vendors/customers?
- Is there a shareholders' or similar agreement that limits (or expands) your estate's rights regarding your interests?
- How do you take care of beneficiaries who are not involved in business?

Lifetime Concerns

- Defection of key employees
- Unwanted transfer of interests by a co-owner
 - Voluntary transfers
 - Death, bankruptcy, divorce, etc.
- Refusal of co-owner to join in a sale opportunity
- You become incapacitated
- Loss of income upon retirement
- Family not ready to take over upon your planned or unplanned exit
- Family never will be ready/interested
- Liquidity/investment diversification

Addressing Operational Concerns

- Identify key employees and “transition team”
 - Who is most important to current and future operations?
 - Transition can mean preparation for sale or preparation for transfer to next generation
 - Identify investment banking, accounting, financial, and legal professionals to assist in positioning business for lifetime or post-death sale if that is intent
 - Employees/team members might or might not include family members
 - Non-family team might have to run business until family is ready to take over

Addressing Operational Concerns (cont'd)

- Identify key employees and “transition team” (cont'd)
 - Segment into
 - Daily operations
 - Board of directors
 - Voting control – should someone other than children/others who ultimately will own interests control voting for some period of time?
- Incentivize retention – especially after you become unavailable
 - Employment agreements
 - Equity substitutes – phantom stock
 - Non-voting interests
 - ESOP – more later

Addressing Operational Concerns (cont'd)

- Disincentiveize defection
 - Non-compete clauses
- Key man life insurance
- Train family
 - Lifetime involvement
 - Family councils
 - Get out ahead of the issues
 - Who is interested?
 - Who is not?
 - Who is qualified?
 - Who is not?

Addressing Operational Concerns (cont'd)

- Utilize trusts and trust directors to hold (and vote) interests of beneficiaries who are not ready for ownership (funding can occur while living and/or after death)
 - Can be pending sale or until next generation is ready for ownership
 - Can be used to manage business during lifetime of surviving spouse
 - You can give trustees or trust directors discretion to determine whether sale or transition is best
 - E.g., you craft this part of your plan at a time when the jury is still out on family's interest/ability
 - Trustees or trust directors may or may not be employees or board members – but they will control voting on matters such as selection of board members to the extent that trust holds voting interests
 - Trusts may play a tax planning role even where next generation is already prepared to run business – more later

Addressing Operational Concerns (cont'd)

- Have appropriate Power of Attorney in place to manage your interests while you are living but incapacitated
 - You can (but do not have to) designate a special agent to deal exclusively with business interests, while spouse or other agent handles your other affairs
- If agent is not business savvy and there are impediments to designation of a special agent, make sure your agent knows who to consult regarding the business

Addressing Operational Concerns (cont'd)

- Is sale of business to a third party a realistic alternative?
 - Discuss with corporate counsel/investment banker
 - Importance of regularly prepared financial statements (audited if possible, at least reviewed or compiled)
 - 3–5 year history of performance or demonstrated growth trend
 - Effect of “add-backs” on valuation

Addressing Co-Owner Concerns

- Shareholders Buy/Sell or Similar Agreement
- Transfer restrictions
 - Are you free to transfer?
 - Can others transfer to unwanted transferees?
 - Should other shareholders have to consent to all transfers?
 - Should intra family transfers be allowed?
 - Should transfers to trusts be allowed?
 - Should there be rights of first refusal?
 - Restrictions do not have to be same for majority and other owners
 - Be aware of “S-corporation” limitations

Addressing Co-Owner Concerns (cont'd)

- Transfers at death or disability
 - Restricted or unrestricted
 - Options and redemption provisions
 - Mandatory or optional purchase/redemption
 - Can be means of providing estate liquidity
 - Valuation method
 - Payment method/Timing–Cash and/or promissory notes
 - Redemption or cross purchase
 - Life insurance to fund all or part of purchase price
 - Should company/other shareholders be required to buy all shares?

Addressing Co-Owner Concerns (cont'd)

- Other Involuntary transfers/triggering events (bankruptcy, divorce, termination of employment, etc.)
 - Options and redemption provisions
 - Valuation method
 - Payment method/Timing–Cash and/or promissory notes
 - Redemption or cross purchase
 - Should company/other shareholders be required to buy all shares?
 - Should there be flexibility to buy only voting shares
 - Provisions do not have to be the same as those that apply at death of a shareholder

Addressing Co-Owner Concerns (cont'd)

- Drag-Along and Tag-Along Rights
 - A minority shareholder has potential to create a significant impediment to a third-party sale
- Marital agreements
 - Your spouse
 - Your children/other beneficiaries
 - Co-owners

Addressing Liquidity/Investment Diversification Concerns

- ESOP?
 - Liquidity
 - Control
 - Tax benefits to you and company
 - Unique employee benefit
 - Give employees vested interest in growth/success

Benefits of Lifetime Transfers

- Valuation discounts
- Valuation freeze and tax reform window
- Transfers to certain trusts can remove assets from gift, estate, and GST tax for an unlimited number of generations
- Can be funded with nonvoting interests
- Members of transition team can serve as trustees and/or trust directors
- Creditor protection

Benefits of Lifetime Transfers (cont'd)

- Valuation freeze and tax reform window – married couple example

Business Value	\$45,000,000	\$70,000,000
Percentage Gifted	49%	49%
Undiscounted Value	\$22,050,000	\$34,300,000
Discounted Value @ 35%	\$14,332,500	\$22,295,000
Value of Retained Interest	\$22,950,000	\$35,700,000
Years Until Death (2026)	6	6
Assumed Annual Growth	5%	5%
Value of Retained Interests at Death	\$30,755,195	\$47,841,494
Undiscounted Gifted Interests at Death	\$29,549,109	\$45,965,280

Benefits of Lifetime Transfers (cont'd)

- Valuation freeze and tax reform window – married couple example

2020 Exclusion	\$23,160,000	\$23,160,000
2020 Gift	\$14,332,500	\$22,295,000
Exclusion Remaining After Gift	\$8,827,500	\$865,000
Exclusion Remaining After 2025	\$0	\$0
Taxable Estate in 2026 (Business Only)	\$30,755,195	\$47,841,494
Exclusion Available	\$0	\$0
Taxable	\$30,755,195	\$47,841,414
Tax at 40%	\$12,302,078	\$19,136,597
Value Transferred at Death	\$18,453,117	\$28,704,896
Value Transferred During Life w/o Tax	\$29,549,109	\$45,965,280
Value held by Heirs After Death	\$48,002,226	\$74,670,176

Benefits of Lifetime Transfers (cont'd)

- Valuation freeze and tax reform window – married couple example

<u>Tax Without Planning</u>		
Taxable Estate in 2026 (Business Only, at 5% Growth w/o Gifting)	\$60,304,304	\$93,806,695
Exclusion Available (Estimated)	\$13, 120,000	\$13,120,000
Taxable	\$47,184,304	\$80,686,695
Tax at 40%	\$18,873,722	\$32,274,678
Net to heirs	\$41,430,582	\$61,532,017

Benefits of Lifetime Transfers (cont'd)

- Valuation freeze and tax reform window – married couple example

<u>Savings</u>		
Tax Without Planning	\$18,873,722	\$32,274,678
Tax With Planning	<u>\$12,302,078</u>	<u>\$19,136,597</u>
Tax Savings	\$6,571,644	\$13,138,080
Net to Heirs Without Planning	\$41,430,582	\$61,532,017
Net to Heirs With Planning	<u>\$48,002,226</u>	<u>\$74,670,176</u>
Difference	<u>\$6,571,644</u>	<u>\$13,138,159</u>

Benefits of Lifetime Transfers (cont'd)

- Valuation freeze and tax reform window – married couple example
 - Does not take into account assets other than business or estate tax deductions
 - Does not take into account capital gains tax and basis step-up
 - No impact if sale before death
 - Unpredictable impact if family intends to maintain business indefinitely
 - Must be analyzed if sale shortly after death is anticipated

Benefits of Lifetime Transfers (cont'd)

- Trusts known as “GRATs” and “IDGTs”
 - Can substantially reduce or even eliminate use of exclusion and payment of tax
 - Particularly useful if amount of available exclusion is limited
 - You receive annuity payments (GRAT) and may receive installment payments (IDGT)
 - Particularly useful upon retirement
- Employment or management agreement for yourself
- Unique opportunities presented by start-ups

When You Die – Trusts for Spouse

- Management of business/other assets
 - Members of transition team can serve as trustees and/or trust directors
- Can facilitate removal of assets from gift, estate, and GST tax for an unlimited number of generations
- Creditor protection
- Prevent diversion to new family upon remarriage

When You Die – Trusts for Others

- Can be funded at your death or surviving spouse's death
- Management of business/other assets
 - Members of transition team can serve as trustees and/or trust directors
- Can facilitate removal of assets from gift, estate, and GST tax for an unlimited number of generations, or can terminate at ages you select
- Creditor protection – including equitable division upon divorce

Providing for Family Members Who Are Not Involved in Business

- Non business assets
- Life Insurance
- Income producing business assets
 - Business Real Estate
 - Growth vs. Distribution
- Specify division of assets vs. undivided division of the whole with options granted to interested heirs
 - Valuation
 - Timing
 - Cash vs. Notes

Providing for Family Members Who Are Not Involved in Business (cont'd)

- Consider impact on family dynamic
 - Are non-participating children at the mercy of the business acumen of those who will run the business?
 - How much of the family dynamic issue could have been resolved through a lifetime family council?

Funding Tax Liability at Death

- Redemption/cross purchase requirements
- Life Insurance
- Second to Die
- ILITs

If you have questions:



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THANK YOU!