Reprinted from:
BLUEPRINTS
May 3, 2004

PROTECTING YOUR BUSINESS AND YOUR ESTATE

By David M. Kauppi President
Mid Market Capital, Inc.

As Penn State professor William Rothwell ominously points out in the forward to Exit Right: A Guided Tour of Succession Planning for Families in Business Together, more than 40% of the people who run the closely held operations that comprise 80% of the North American economy will retire by 2007. Those businesses will either be sold to a third party or management team, closed down, or passed on to the next generation, which is the focus here.

Tax laws still favor home ownership with mortgage interest as a tax-deductible expense. The government has also encouraged the passing of a business from one generation to the next with several favorable estate and gift tax rulings. Estate planning attorneys have utilized IRS ruling 5960 to minimize the estate and gift tax owed for a business either gifted to or inherited by the next generation. The business is often placed in one or more LLC's and divided up into minority pieces to take advantage of very substantial and legal minority discounts, often as high as 40%.

A business owner will have, for example, 4 children. Two sons will be actively involved in running the businesses and two daughters have built lives separate from the business. Because 85% of the value of the estate is tied up in the value of the business, to be "fair" the business is gifted and willed to the four siblings in almost equal proportion. Because the sons are running the business, they will get slightly more of the business and slightly less of the remaining estate. This gives them majority interest in the business. After dad leaves the business, the two sons will continue to run and grow the business without any input or participation from their two sisters.

Typically the business does not pay any dividends and the two sisters' portions are non-liquid because there is not a good market for selling minority stakes in a privately held business. There is generally a very restrictive buy sell agreement that favors the majority holders. The sisters have no idea what the "fair value" of the business is, with their only indication an official IRS gift tax or estate tax return with 40% discounts applied. If the enterprise value were, for example, $50 million and the two sisters owned a combined 40%, you would think that they had an asset worth $20 million.

The only document they have seen, however, is the gift or estate return, valuing their portion at only 60% of that number, or $12 million. The brothers feel entitled to the lion's share because the sisters had nothing to do with building this business. The brothers pay themselves big salaries and benefits and pay out little of no dividends. They may approach the sisters with gift tax return and restrictive buy sell agreement in hand and offer to generously buy out the sisters for a combined 8 million, because that is "all the company can afford to pay."

BLUEPRINTS
The Business Ledger May 3, 2004 B7
Protecting your business and your estate
By David M. Kauppi
ON THE LINKS
Golf Guide

After this transaction takes place, let's look at how dad's estate was fairly divided. Originally the brothers were left with 60% of the $50 million business, or $30 million and a minor portion of the remaining estate. The sisters were left with 40% of the business, or $20 million and the bulk of the remaining estate of $10 million. That appears to be fair. However, the buyout of the sisters for a combined $8 million results in an effective estate distribution of $42 million to the brothers and $18 million to the sisters. This is not what dad intended, but it happens all the time.

This is a very complex and emotional issue and there are no simple answers. Generally, dad had his identity tied up in the business and wants it to live on through his sons. This is a noble, yet impractical thought if all the siblings are not actively involved in the business. The children often inherit the restrictive buy sell agreements that favor the brothers running the business and scare off investors that may have been interested in a minority stake.

Much of the value from a privately held business is derived from the benefits of working in the business. There is the very real concern that the integrity of the gift or estate tax business valuations will be compromised if the sisters are bought out at a price approaching a pro-rated division of total enterprise value.

Unfortunately, in most cases, nothing is done and as a result there are literally hundreds of billions of dollars of minority interests in privately held business that are providing little return or no return to their owners. One of the keys to unlocking the liquidity in these minority interests is for the business owner to recognize this situation prior to building his estate plan. Unfortunately, after the fact, a fair outcome is contingent upon the majority owners honoring dad's original intent of fairness and working toward that end.

David Kauppi is a Merger and Acquisition Advisor with Mid Market Capital, Inc. MMC is a private investment banking and business broker firm specializing in providing corporate finance and business intermediary services to entrepreneurs and middle market corporate clients in a variety of industries. The firm counsels clients in the areas of M&A and divestiture, succession planning, valuations, corporate growth and turnarounds. Dave is a Certified Business Intermediary (CBI), a licensed business broker, and a member of IBBA (International Business Brokers Association) and the MBBI (Midwest Business Brokers and Intermediaries). For more information or a free consultation please contact Dave Kauppi at (630) 325-0123, email davekauppi@midmarkcap.com or visit our Web page www.midmarkcap.com.

David M. Kauppi