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College of Business

The Goering Center
FAMILY BUSINESS REPORT

Solutions, technologies and shared experiences unique to the family or privately held business.

DIRECTOR'S COLUMN:

How do you Spark Interest and Develop Successors for your Family Business?

W. Kent Lutz, Director

Goering Center "Executive Luncheon Series" Continues May 25, 2004, From 11:30 am -1:30 pm With The LaRosa Family and T.D. Hughes

Goering Center "Members Breakfast Series" Continues June 22, 2004, From 7:30 am-9:30 am With Paul Bransford and Lynn Mangan

Children will more likely want to join and be leaders in the family business someday if they are exposed early on to its many rewards and satisfactions. This all begins by expressing the joys that come from the business, taking the kids to the office at an early age, providing a role model for them, and not complaining about all the stress and hard work. We all know that our children have minds of their own and often want to do their own thing. In fact, it's very healthy to encourage our children to pursue their own dreams and to discover where their gifts and talents really exist. Parents who are secretive about their work, who always appear overworked and overstressed at home, and forever bad mouth the business, really cannot expect their grown up children to suddenly express enthusiasm for joining the family firm. It's all too easy to only show the frustrations of the business at home, since home tends to be a safe place, rather than all the joys and satisfaction the business really provides.

Most of us learn to seek fulfilling careers by observing roles models. A role model is anyone we may admire and who has values that can be looked up to and patterned after. In a family business taking a young child to the office and letting them see the fun part of the business can foster affection for the business and allows the parent to role model in a little different way. As the child gets older, it's important to help them understand that working for the family business is not an entitlement, however, but rather it should be earned just like any other great opportunity. Tough rules and high standards of employment need to be established and enforced in the family business for all family members, just as it is for all non family employees, in order for the business to continue to thrive. The business must be protected, and it can only be preserved by having highly motivated successors, cooperative stakeholders, a key management team, and outside board members who can be totally objective in their advice. The best business structure is established by ensuring that those in power have the authority to make important decisions, subject only to outside board review. Such a structure may take time to develop, but over time will greatly enhance the business-es value, both to the family and to all key stakeholders in the business.

Parents and children should begin talking about matters of joining the family business long before such an event may actually take place. The choice of new leadership in the business should never wait until an actual crisis develops, but rather needs to be planned years in advance. Many parents worry that if they encourage their children to gain valuable experience elsewhere, they will never come back to the family business. Well, the fact is that if the business really is of no interest to them, they would be better off not joining the family firm. There are lots of examples of third and fourth generation family firms that present pictures of warring tribes and rampant entitlements, where ownership is divided among scores of shareholders and families may be fighting for jobs and perks. In order to protect the real value of the "Golden Egg" (the business), chaos needs to be eliminated and leadership needs to be in the hands of those that work for the welfare of all. Excellent talent is hard to find, and most talented young people want to be part of an organization that is well managed, has a reputation for making quality products, is open with its employees, serves its customers with excellence, and treats

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Inside...

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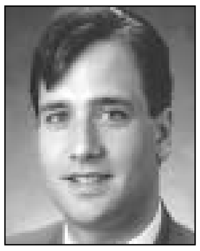
GOERING CENTER

Succession Planning: Ownership Transfer Techniques for Private Business Owners

Deloitte & Touche

Christopher J. Kramer, Deloitte & Touche

There are many challenges facing private business owners who are planning to transfer ownership in their company to the successor generation. Will the transfer of the business provide adequate cash flow to fund the senior generation's retirement needs? How much tax must be paid? Will the ownership transfer cause a liquidity crisis for the business or the younger generation? Who should get the company stock: the successors who are active employees of the business or others who are not active? Do the successors want stock? Are the successors ready to assume voting control of the company? Is equal ownership amongst successors fair? Can the successors afford to buy the company?



These are all tough questions that directly impact which ownership transfer technique is most appropriate. The good news is there are many ownership transfer options available today.

Outright Sale to Successors

The most obvious option is an outright sale of the company to the successors. Buyers may purchase stock or assets. If an asset purchase is executed, a tax deduction in the form of depreciation and amortization may be had for the buyer. But the tax effect on the seller must also be considered. For example, the sale of certain assets may result in ordinary gain rather than capital gain treatment resulting in higher income tax rates for the seller. There are also tax rules that restrict the amount of losses afforded on sales between related parties. And if the business was owned by a related party before and after July 25, 1991, purchased goodwill may not be deductible by the buyer.

The primary advantage of an outright sale is the avoidance of transfer (estate and gift) taxes, as long as the sale is made in an arm's length transaction and any note given by the seller is satisfied before the seller's death. However, the sale of a closely held business to a family member at an unreasonably low price may be challenged by the IRS as a disguised gift. The primary disadvantage of an outright sale is the income tax cost to the seller, and the fact the buyer is using after tax dollars to pay for the business.

Aside from income tax problems, there are sometimes practical difficulties with an outright sale. Sometimes the successor generation does not have the financial wherewithal to buy the company, requiring the seller take a loan in exchange for stock, rather than cash. In this case, the seller must rely on the talent of the next generation management team to maintain the appropriate level of business prosperity required to service the debt. This is particularly important when the sellers rely on cash flow provided by the note to fund retirement needs.

Gifts of Ownership

The motivation in gifting closely held stock to successors is usually to save transfer (estate & gift) taxes. Currently, individuals may make annual gifts of up to $11,000 per recipient without any transfer tax consequences. Married couples can combine to gift up to $22,000 per recipient per year. Over a period of years, significant amounts of closely held stock can be transferred through gifting. When it is anticipated that the company stock will appreciate significantly in value, it may make sense to gift more than the annual $11,000 exclusion to take advantage of the fact that the post-gift appreciation is also removed from the donor's taxable estate.

There are problems with using outright gifts as the primary stock transfer strategy. Depending on the size of the company, annual exclusion gifting may take too long. At $11,000 of value per year, it may be impossible to transfer all the stock by gifting the annual exclusion, even over a span of decades. And if the senior owner dies before the transfers are complete, the ungifted ownership interest may be subject to the estate tax.

Recapitalization and Discounted Gifting

Instead of gifting 100% of the company stock to the successors, closely held business owners may take advantage of certain valuation discounts afforded to non-voting stock which can reduce the tax cost of the transfer. Before executing the gift of stock, the closely held business may recapitalize its equity into voting and nonvoting shares. The voting interest represents the management element of ownership, and the nonvoting interest represents a passive investment ownership interest. In order to facilitate gifting, the ratio of voting shares to nonvoting shares would be disproportionate, say 1 – 10. The owner then gifts the nonvoting shares to the successors, while retaining the voting shares. The shares gifted will qualify for valuation discounts for lack of marketability and lack of voting power. And because 90% of the company's equity is assigned to the nonvoting shares, almost 90% of the taxable value of the company can be transferred to the successor generation at discounted amounts. Most importantly, this approach allows the senior owner to retain management control of the business while removing taxable value from his or her estate.

These are all tough questions that directly impact which ownership transfer technique is most appropriate. The good news is there are many ownership transfer options available today.

Grantor Retained Annuity Trusts (GRAT's)

An alternative which accomplishes ownership transfer of a closely held business, provides retirement cash flow for the senior owner, and may accomplish substantial estate and gift tax savings is known at the Grantor Retained Annuity Trust or GRAT. Using this strategy, the senior owner transfers his or her stock into an irrevocable trust in exchange for an annuity payment (from the trust to the senior owner) over a fixed period of years. The GRAT has a fixed term of years and after the term expires, the stock passes to the successor owners. Any gift tax is reported and paid on the date of the transfer of the stock into the trust. The gift value of the stock placed in trust is reduced by the value of the annuity. Therefore, the taxable value of the gift can be reduced by assigning a longer annuity period, or by increasing the amount of the annuity payments.

The GRAT affords the senior owner's estate a "freeze" on the appreciation from the company's stock which saves estate and gift taxes. It also provides cash flow to the senior owner during a portion of his or her retirement years to help supplant income given up during retirement. And the GRAT can be structured so the senior generation maintains control of the voting stock during the GRAT term.

A recent tax ruling involving the Walton family, founders of the Wal-Mart retail stores chain, allows grantors to set the annuity payout in a GRAT at a level that may significantly reduce or eliminate the up-front gift tax liability when transferring company stock into the GRAT.

The risk of a GRAT transaction is that if the senior owner dies during the GRAT term, the stock in the GRAT reverts back into his or her taxable estate. To help counter this effect, many GRAT's have a reversion clause that states in the event of the death of the senior owner during the GRAT term, the GRAT property comes back into the estate and will be disposed of by the surviving spouse, allowing the decedent's estate a marital deduction thus deferring the estate tax on the GRAT property.

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The Family Business Report

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All Shares Are Not Created Equal

Michael L. Dailey, CPA, CVA, Fifth Third Bank

The politician Robert F. Bennett is credited with saying, "A desire to be in charge of our own lives, a need for control, is born into each of us. It is essential to our mental health, and our success, that we take control." That's a pretty profound thought, a little too poetic to be included in a business valuation report, but I did use it in my book, For What It's Worth. Although Bennett was obviously not talking about the value of closely-held businesses, his words do have some specific relevance there. It is human nature to want to call the shots on some level, either at home or at work. Control is something that we tend to strive for, fight for, or even pay for.

With that serving as a backdrop, follow me through a quick example. Based on a recent valuation report, it is determined that your entire privately-held company is worth $100,000. If there are 100 shares of stock in this company, what is one share of stock worth? Some simple grade school math would tell you that $100,000 divided by 100 equals $1,000 per share. So that's your answer, your company is worth $1,000 per share. Or is it? The valuator issued a report opining to the value of the entire company, not just one share. Is there a difference? You bet your goodwill there is.

There is a difference in the general nature of the blocks of shares we are dealing with here. If you broke your 100-share block of ownership into one 99-share block and another 1-share block, what is the difference in the nature of these blocks? Well, for starters, the 99-share block retains control of the company. As long as you are not breaching any fiduciary responsibilities, you are well within your power as a 99% owner of the company by ending each and every shareholders' meeting with an "Oh, by the way, you're ugly," while implementing absolutely none of the 1% shareholder's ideas for changing the way your business does business. The ownership structure may have changed, but the control over the business hasn't budged a whit.

Now let's revisit the question at hand. Grade school math aside, what is the value of one share of stock in this business worth? The short, cynical answer is zero, especially given the majority owner's propensity for insults at the shareholders' meetings. The actual answer would be some derivative of the total company value on a per-share basis, but it would be a bit less than the strict percentage of total value.

What if the two ownership interests were equal? A 50%-50% ownership structure? In this case, nobody would really have true control over the company because every difference of opinion would result in a deadlock. You would be sailing the high seas in a ship with two first mates but no captain. In this example, each block of ownership would suffer some deterioration of value because of the lack of control. Would it not follow that the overall company value would be diminished because both blocks had to suffer some loss in value attributed to this lack of control? Perhaps. It would really depend on the actual circumstances in play.

Mechanically, this deterioration in value is represented in a business valuation through the application of a discount for lack of control, or what is sometimes called a minority interest discount. Discounts like this are used to modify a calculated value from one level of value to another. A control level of value assumes that the specific ownership interest being valued actually has control over the company. If, however, the subject interest has no real control, a discount would be applied to compensate the owner or buyer of the interest for the lack of control. There are multiple ways to value a business, and some of these methods inherently assume that no effective control is present. What this really means is that, while this discount is available, it doesn't always apply; sometimes it is already built in to your calculations.

Great, so I have just erased a portion of your company's value by telling you that not all shares are created equal. How can you use this to your benefit? The most readily available benefit of lack of control discounts is the gifting or estate plans you may be using. Gift tax regulations draw some limitations around just how much you can gift to someone without incurring gift taxes. The current limitation is $11,000. If you wanted to transfer a chunk of your business ownership out of your estate without paying gift taxes, then the appropriate application of this discount means that you might be able to transfer a larger portion of the equity in your company each year than you initially thought. What might first appear to be a $15,000 gift could actually prove to be only a $10,000 gift. Not only is this a strong wealth planning strategy, it is perfectly legitimate when properly calculated and presented.

Michael L. Dailey, CPA, CVA is a Senior Wealth Planner with Fifth Third Bank, and the author of For What It's Worth, an introduction to business valuation. You can reach him at 513-534-5355 or Michael.Dailey@53.com.

It's Time to Sit Around the Boardroom Table and the Dinner Table to Discuss Derivatives

PNCBANK

Kristie Sheanshang, PNC Commercial Bank

If you are an entrepreneur starting your first business endeavor, if your family firm has been in business since World War II, or if you are the CFO of a Fortune 50 company, you probably paused when hearing the financial media reporting close to a 70 basis point increase in long-term interest rates. Many experts had been expecting an increase in rates, but few could foresee this drastic jump that would happen over just a two-week period. The bond market had been watching closely for any improvement in the employment situation, and this improvement was realized in the first week of April. Data released by the government showed that, for the month of March, there were over two and half times as many jobs created than had been anticipated. Since market makers had been worried about the lagging job situation, this strong employment report was the last piece of the puzzle that needed to fall into place for them to feel comfortable that the economy was improving. And this is just the beginning. While a strong economy certainly is very desirable, between the subsequent demands for capital, the Federal Reserve's desire to keep inflation at bay, continuation of job creation, and as the economic picture further brightens; we can expect to see short and long term rates continue to rise.

Take this forewarning as an opportunity to sit down with your management team around the board table or the dinner table and determine your long-term capital requirements, and plan today for tomorrow's interest rate environment.

During this discussion, interest rate derivative products should not be overlooked. The two most common derivative products for businesses are the Interest Rate Swap and Interest Rate Cap. In simple terms, an Interest Rate Swap is a vehicle used to alter the type of interest rate exposure on a company's existing debt. The most common use of a Swap is to lock in a fixed rate on a piece of floating rate debt. It will limit the company's exposure to rising interest rates and at the same time, accrue positive value as rates rise. This provides the additional benefit that if the loan is terminated prior to maturity, and the Swap has accrued value from rising interest rates, the company can receive the accrued value in payment for the termination.

There are numerous other advantages as well, including: no upfront fees, rates similar to traditional bank rates, flexibility in swapping the entire or a portion of the loan amount, and transferability of a Swap to a future loan. In one real life example, several years ago a local distributor utilized a Swap to minimize its interest rate risk on one of its four long-term notes (the other three notes utilized a "traditional bank fixed rate.") Indeed, rates did rise to the point where the rate provided by the Swap was lower than short-term rates. Shortly thereafter, the company decided to sell one of its divisions and realized a cash windfall. As management and the banker considered the utilization of these cash proceeds, the banker determined that by retiring the debt of the note with the Swap, the Swap could be sold back to the market and the company would yield an additional $80,000 profit. When a loan with a traditional bank fixed rate is retired early, no such benefit is realized by the company.

Another option to consider is the Interest Rate Cap. The Cap serves as an insurance policy and establishes the highest interest level, or ceiling, that the company will pay on its floating rate debt. Prior to reaching the pre-set ceiling, the client enjoys the present lower floating rate. There is an upfront fee for a Cap, which is calculated based upon the level of the

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Goering Center for Family & Private Business
Family Business Executive Luncheon Series
presents
Buddy LaRosa, Mike LaRosa and T. D. Hughes, LaRosa's, Inc.
May 25, 2004 - 11:30 - 1:30 Lunch Program
Quality Hotel & Suites 4747 Montgomery Road, Norwood, Ohio

Sponsored by: Mellott & Mellott, P.L.L. KeyBank

In 1954 Buddy LaRosa's passion was to build his own business. With only a couple of partners, $400 cash, and his Aunt Dena's pizza recipe, Buddy opened a small pizza parlor to serve his neighborhood. Now, 50 years later, LaRosa's, Inc. serves hundreds of neighborhoods throughout Greater Cincinnati and Northern Kentucky, the Miami Valley and Southeast Indiana.

Buddy's sons Michael, President and Chief People Officer, and Mark, Executive Vice President of Food and Product Development, graduated from the Goering Center's Next Generation Institute. In 2000, LaRosa's, Inc. received a Goering Center *Family Business of the Year Award* in the category of Community Service.

Join us to hear some of the challenges in transition planning the LaRosa family has encountered and what it's like for a non-family member to have a key leadership position within a highly successful family business.

Yes! I'll attend the Family Business Executive Luncheon on May 25, 2004

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ceiling, the dollar amount to be protected, and the tenor of the Cap. Frequently, this fee can be financed into the loan. The advantage of the Cap is that the rate on the debt floats at today's 40-year low interest rates at the time when the principal amount is at its highest – creating the largest interest rate savings - while still protecting you from a sharp increase in rates that would negatively impact your business.

Strategically, Interest Rate Caps should be considered when you believe that short-term floating rates will not exceed the long-term Swap rates over the course of the loan, and yet you desire to be protected in the case of unforeseen worst-case circumstances. For example, last year a local convenience store consolidated its long-term debt into a new seven-year note. The owner preferred the floating rate of 4.00% to a fixed Swap rate of 6.50%, but has memories of a Prime rate of 21.00% in 1981 and did not want to be exposed to that risk. Thus, the interest rate was structured as floating at 4.00% (Prime) and a Cap was purchased at 7.00% with the cost rolled into the new note. Over the last fourteen months the company has enjoyed the lower floating rate with the comfort of knowing it is protected from very high rates. The savings of the lower floating rate of 4.00% versus the 6.50% Swap rate have almost paid for the Cap, with 46 months of savings left to be realized.

While a strong economy certainly is very desirable, between the subsequent demands for capital, the Federal Reserve's desire to keep inflation at bay, continuation of job creation, and as the economic picture further brightens; we can expect to see short and long term rates continue to rise.

There are a few other items for you to consider when utilizing an interest rate derivative. First, the typical index for floating rate debt in the United States is Prime. However, there is a trend of more companies requesting LIBOR-based rates (London Interbank Offered Rate), as they are a more common pricing standard for domestic and international banks. Further, LIBOR is more a true market-based rate versus Prime, which is more heavily influenced by geopolitical issues such as this fall's Presidential election. Second, you want to fully understand who is involved in the placing of your Interest Rate Swap or Cap. Some institutions maintain their own trading desk while others subtly utilize a third party. It is in your best interest to deal directly with the trading desk so that in the event that you have a question, issue, or desire to restructure the facility, you will know who you're dealing with. Third, when contemplating your interest rate options, give full consideration to all current and future debt. We generally believe it is best to have a blend of floating and fixed rate debt, so plan ahead if you are aware of future debt needs so that your overall interest rate structure can be optimized Finally, consult with all of your advisors – banker, accountant, attorney, board of directors, siblings in the business - so all angles are covered.

By utilizing these derivative products, your start-up business, family business, or publicly-traded corporation is able to structure the right interest rate protection generating the lowest interest expense and highest flexibility allowing you to focus on running your business and to confidently budget for the long term.

Kristie Sheanshang is a Business Advisor and Vice President of Commercial Banking for PNC Bank in Cincinnati/Northern Kentucky and can be reached at 513 651-8950.

Goering Center for Family & Private Business - Executive Breakfast Series

June 22, 2004, 7:30 - 9:30 A.M.

Father & Daughter

Paul Bransford, Founder, Bransford Retirement Plan Services, Inc., Retired Regional President, Invesmart, Inc. ***and*** **Lynn Mangan, Vice President and Regional Director, Invesmart, Inc.**

Quality Hotel & Suites 4747 Montgomery Road, Cincinnati, Ohio 45212

Often when we are in family business, we do not take the time to develop and most importantly *execute* a succession plan. Learn how the execution of a preplanned strategy led to a smooth succession at Invesmart in Cincinnati despite a major "surprise" and how this might apply to your business.

Paul Bransford, the founder of Bransford Retirement Plan Services, Inc. and his daughter, Lynn Mangan, one of six shareholders of Bransford, will discuss their personal experiences of developing and executing their succession plan.

Yes! I'll attend the Executive Breakfast on June 22, 2004.

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its suppliers fairly.

Many family firms offer this type of opportunity, but it doesn't just happen-it must be planned.

Parents who are secretive about their work, who always appear overworked and overstressed at home, and forever bad mouth the business, really cannot expect their grown up children to suddenly express enthusiasm for joining the family firm.

With a well thought out plan of succession, offering early exposure to the joys of being part of a family firm, being a role model to be admired, and creating challenging opportunity, senior members of a family business can successfully attract their children to the family firm. A well managed family business can offer children tremendous opportunities for both personal and professional growth, as well as, financial success. The family firm can offer the best of all worlds, but there must be a senior generation role model that will make the next generation proud and thus desire to become part of the firm.

Remember, we are here to serve your needs. Please consider joining the Center as a member company. The cost is modest and the value is enormous. We want to assist you…..Until next time…..WKL

Succession Planning..continued from page 2B

Installment Sale to a Grantor Trust

This technique is similar to a GRAT in the sense that the business interest is transferred into a trust. But rather than gifting the stock to the trust, the senior generation sells their ownership interest to a special trust called a grantor trust in exchange for an installment note from the trust. The grantor trust is disregarded for income tax purposes but respected for estate tax purposes. Because the sale takes place between an individual and a grantor trust, no income tax is assessed on any gain on the sale to the trust. And because the trust is respected for estate tax purposes, the stock has been removed from the seller's taxable estate and replaced with the installment note from the trust.

Using this technique, the business must be in the form of a pass through entity like an S-corporation, partnership, or limited liability company. As time passes, the cash generated by the business is distributed to the trust. The trust then uses the cash received form the company distributions to pay back the installment loan to the senior owner. After enough cash has cycled through the trust, the note will be paid off and the transaction is complete. The stock is removed from the taxable estate of the owner, and is held in trust for the successor beneficiaries.

Employee Stock Ownership Plans (ESOP's)

An ower may wish to transfer the company to all the rank-and-file employees by use of an employee stock ownership plan (ESOP). ESOP's are IRS qualified retirement plans that invest in the stock of the employer. Many employers have discovered that there are inherit benefits in affording ownership to employees of their company including pride, team spirit, and a grass-roots interest in the financial success of company operations.

An ESOP can not discriminate in favor of certain groups of employees. The ESOP must be set up to benefit all eligible employees of a closely held company. Eligible employees are usually those individuals who are at least 21 years old, work full-time in the company, and have at least one year of full-time service with the company.

The company makes tax deductible cash contributions to the ESOP which is used to buy the company stock from the current owner. There are statutory limitations on how much cash the company can contribute for each employee. However, if the owner desires to sell a larger block of stock in a lump sum, the ESOP can borrow the cash from a bank to accomplish the purchase. The annual tax-deductible contributions to the ESOP can be used to service the bank debt.

If properly structured to comply with IRS requirements, the owner may roll over the proceeds from the sale of the closely held stock to the ESOP into other domestic marketable securities, and defer the tax on the gain of the sale of the company to the ESOP.

The techniques described above represent only a few of many ownership transfer options available to closely held business owners today. It is important to note that the decision to pass ownership to the successor generation is a single piece of the succession planning puzzle. Closely held business owners must coordinate the mechanics of the ownership transfer plan with their individual retirement goals, estate plans, and the timing of the management development program for the next generation.

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Singer Wallcovers
Star Moving and Storage
Sunbelt Business Brokers of N KY
The Angus Group Ltd.
The Child's Center
The Global Consulting Partnership
The Gorilla Glue Company
The Greater Cincinnati Foundation
The Imbus Roofing Co., Inc.
The Lumley Group, Inc.
The Verdin Company
The Walt Lunsford Financial Advisory Group of Advest, Inc.
The Wise Group
The Wolfe Practice, LPA
Trans-Borders Technology
Truitt Roofing Company
Unistrut Cincinnati
University of Cincinnati College of Business
U S Bank
Verst Group Logistics
Vinylmax LLC
Wardway Fuels, Inc.
Whetstone Management
Wilson Assoc. Financial Group
Wm. Kramer & Son, Inc.
Woodlawn Rubber Co.

The Goering Center Calendar of Events

May 2004

25th Family Business Executive Luncheon Series – Norwood Quality Inn – 11:30 a.m. Buddy and Mike LaRosa, along with T. D. Hughes, LaRosa's, Inc.

27th Quarterly Economic Roundtable 7:30 – 9:00 a.m. Goering Center, Lindner Hall, Room 101

June 2004

4th Board of Advisors Meeting

8th Next Generation Institute Retreat and Graduation

22nd Member Breakfast Series – Norwood Quality Inn – 7:30 a.m. Paul Bransford and Lynn Mangan Generational Transition

27th Family Business Executive Luncheon Series – Norwood Quality Inn – 11:30 a.m. Speaker to be announced

30th Family Business of the Year Applications Due

August 2004

24th Family Business of the Year Event Cincinnati Music Hall 6:00 – 9:00 p.m.

Please call the Center at 513-556-7185 if you would like additional information on Center membership, or visit our web site at www.Goering.uc.edu.