Succession Planning Strategies for Family Owned and/or Closely Held Businesses

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This is the Story of a Man Named Ned Sundance

The Sundance Family

Ned ⟷ Sue

65 64

Married for 40 years

Mort_Millie 37

Nort 35

Sally_Dr. John 34

Jack 17

Joe 16

Jenine 14

Joanna 10

Rebecca 8

Ned and Sue Balance Sheet

- Assets:

Cash and Liquid Securities		$ 2,000,000
Cabco, Inc. (100%)		10,000,000
Business Real Property (100%)		6,000,000
Planco, Inc. (50%)		2,000,000
Fort Worth Home		1,000,000
Tangible Personal Property		200,000
	Total Assets	$21,200,000

- Liabilities:

None		-0-
	Net Worth	$21,200,000

- Assume: all community property

Ned

100%

Cabco, Inc.

“C” Corporation

Business: Manufacturer of high end restaurant fixtures/equipment

100 employees ($10,000,000 payroll)

Key Management:	Age	Position
Ned	65	President/Director/100% Shareholder
Mort (son)	37	Vice President/Director
Nort (son)	35	Vice President/Director
David	55	CFO – Finance/Treasurer
Steve	50	Vice President - Manufacturing

Business Real Property

- Fort Worth Manufacturing Plant $6,000,000
    - Land & Building (leased to Cabco, Inc.)
    - 15 years old, in Ned and Sue's names

"S" Corporation

Business: Specialized restaurant design work

No employees

Basic Estate Plan Scenarios Result at Second Death

I. Ned and Sue have no estate plan (each dies "intestate" – without a Will).

Gross Estate	$21,200,000	
Federal Estate Tax	< 4,088,000>	
Net to children (outright):		$17,112,000

II. Ned and Sue do estate plan with "credit shelter trust" to utilize both spouse's federal estate tax exemption amounts (currently $5,490,000 each).

Gross Estate	$21,200,000	
Federal Estate Tax	< 4,088,000>	
Net to children (outright):		$17,112,000

Goals and Objectives of Ned and Sue:

1. Assure no estate tax at first death
2. Minimize tax at survivor's death
3. Minimize estate tax exposure to future generations
4. Asset management concerns for children/grandchildren
5. Protection of inheritance of children and grandchildren from third party creditor claims

Goals and Objectives of Ned and Sue:

6. Protection of inheritance from divorce claims against children and grandchildren
7. Cabco management succession (or alternative exit strategies)
8. Planco – management succession (or alternative exit strategies)
9. Economic equality of treatment among children
10. College education for grandchildren
11. Address liquidity concern in light of estate tax

Business Succession Failure Rates After Generation Change

Some studies reflect:

1. Only 30% of businesses continue past the first generation (the business founder) to the second generation (child level).
2. Only 10% survive past the second generation (grandchild level)

Those that succeed through multiple generations…PLAN, PLAN, PLAN…

- All businesses are unique
- Management succession
- Liquidity planning
- Family and company culture
- Planning on transition of influence

Structural Techniques for Ned and Sue's Plan

1. Estate plan documents utilizing estate tax exemptions
2. Estate plan documents utilizing GST exemptions
3. ILIT (irrevocable life insurance trust)
4. Corporate recapitalization
5. FLP (family limited partnership)
6. DGT (defective grantor trust)
7. Buy-Sell agreements
8. Key management non-qualified benefit plans

Ned and Sue Estate Plan

1. One or more trusts are funded by formula in the documents so that trust(s) are created for the survivor funded with the first-to-die's exemption amounts (currently $5,490,000 in assets).
2. No federal estate tax is incurred at first death
3. At survivor's death federal estate tax is minimized by utilization of both spouse's exemptions (currently, $10,980,000 combined).

4. Net combined estate after survivor's death is allocated among the children/descendants, with each child receiving two trusts: a GST Exempt Trust (reflecting the child's share of both spouse's GST exemption amounts currently $10,980,000 combined) and a Non-GST Trust (funded with the child's share of any excess assets).
5. Children who are active in the family business, Cabco, Inc., could be allocated all voting stock in the company, and other assets (including non-voting stock) allocated to the non-active children's shares. Alternatively, voting stock could be allocated equally among all children's shares.

6. Children’s shares (reflecting their inheritance) are maintained in trusts, thereby providing each child/descendant:
   - Federal estate tax shelter (as to the GST Exempt Trusts)
   - Asset protection from third party creditors
   - Enhanced protection from spousal claims in event of divorce (almost like a “prenuptial agreement”).

Ned and Sue ILIT

Ned and Sue decide to pay for new "second to die" life insurance coverage of $4,000,000 to help provide liquidity for estate taxes at the survivor's death.

Settlor: Ned and Sue

Trustee: Mort

Beneficiaries during Settlors' lives: "basket" trust for children and grandchildren ("annual exclusion" gift beneficiaries).

Beneficiaries after surviving Settlor's death: Allocate into three separate trusts:

1. Mort GST Trust
2. Nort GST Trust
3. Sally GST Trust

Trust Assets: $4,000,000 second to die life insurance policy on Ned and Sue.

Ned and Sue during their joint lives can make up to $224,000 per year in annual exclusion gifts to the trust, assuming eight beneficiaries

(2 donors x $14,000 x 8 beneficiaries)

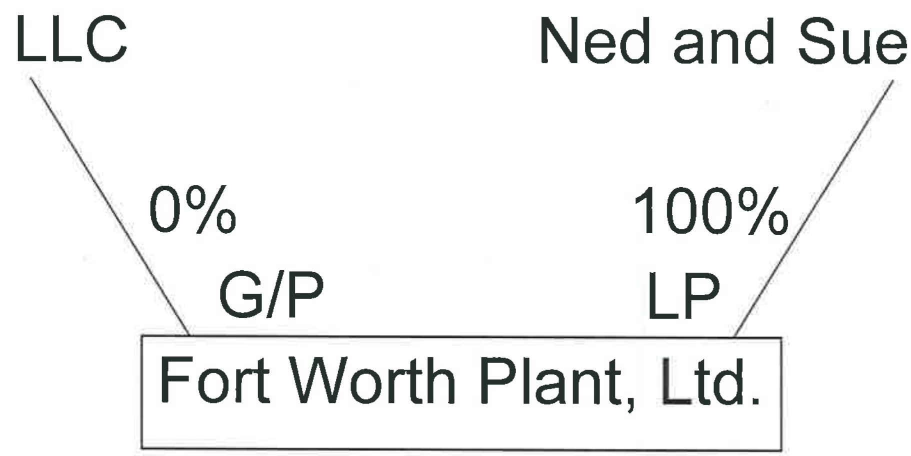
NOTE: Ultimate allocation of proceeds between the three trusts and does not have to be equal – the allocation could provide for a larger allocation for a child if the estate plan were to allocate a family business to other child(ren) who are active in the family business. Life insurance can be an "equalizer" tool.

CABCO
Recapitalization of Stock

Ned and Sue recapitalize their ownership from 100,000 shares of common stock into two classes of stock as follows:

Voting Stock	100,000 shares
Non-voting Stock	900,000 shares

Business Real Property
New Entity Setup



General Partner: Sundance Family Management LLC -0%-

LLC Members: Ned and Sue (Successors: Children)

Limited Partners: Ned and Sue 100%

Assets: Land and building of Fort Worth plant (leased to Cabco)

Children's DGTs

Ned and Sue create three separate trusts, one for each of their children, that are designed as GST trusts <u>and</u> are DGTs (defective grantor trusts) for federal income tax purposes to Ned and Sue.

Mort DGT	Nort DGT	Sally DGT
Settlor: Ned and Sue Trustee: Mort Beneficiary: Mort and his descendants	Settlor: Ned and Sue Trustee: Nort Beneficiary: Nort and his descendants	Settlor: Ned and Sue Trustee: Sally Beneficiary: Sally and her descendants

As long as these trusts remain as DGTs, Ned and Sue will pay the income tax on trust income as if they own the trust assets and can sell assets to the DGTs with no federal income tax consequence.

If Ned and Sue later desire to convert the trusts to complex trusts, they are no longer DGTs, Ned and Sue will no longer pay federal income tax on trust income and can no longer sell assets to the trusts without federal income tax consequences.

Ned and Sue DGTs

Separate trusts are created for Ned and Sue with gifts of up to $5,000 per trust by a living senior member of Ned and Sue's families (perhaps a parent or sibling).

Settlor: Senior family member (not Ned or Sue)

	Ned's Trust	Sue's Trust
Trustee:	Ned	Sue
Beneficiary:	Ned	Sue

Remainder beneficiaries of each trust:

Mort DGT
Nort DGT
Sally DGT

Initial Assets: $5,000 cash

Tax Advantages of DGTs

1. Freezes value of seller's estate
2. Moves future growth to dynastic trusts
3. Avoids income tax recognition on sale
4. Enables non-gift transfers by deemed grantor to trust through income tax payments
5. Depletes deemed grantor's estate by income tax payments
6. Enhances creditor protection

Stages of Corporate Planning In Sales to DGTs

1. CONVERT C CORP TO S CORP (to create pass-through entity)
2. CREATE VOTING AND NON-VOTING STOCK (to retain control and enable valuation discounts)
3. SELECT STOCK FOR SALE TO DGT
   a. VOTING STOCK
      (should not be sold if seller is trustee, but can be sold if seller is not trustee)
   b. NON-VOTING STOCK
      (can be sold regardless of who is trustee)
4. SELECT PAYMENT METHOD
   a. Installment Note
   b. Self-Canceling Installment Note
   c. Private Annuity

Terms of Promissory Note in Sale to DGT Transaction

- Interest Rate (Determined by Applicable Federal Rate (AFR) Rules)

1 – 3 year note:	short-term AFR rate	1.04%	February 2017
4 – 9 year note:	mid-term AFR rate	2.10%	February 2017
10 yrs. Plus note:	long-term AFR rate	2.81%	February 2017

- Payment Options:
  - Amortized Principal
  - Balloon Note
  - Demand Note
  - Self-Canceling Note on Seller's Death
- Prepayments Allowed Without penalty
- Payments-In-Kind Authorized
- Collateral Security: Asset Being Sold
- Guaranty Options:
  - No Guaranty
  - Guaranty of Trustee other than seller
  - Guaranty of Beneficiaries (other than seller) having net worth
  - Guaranty of Third Party for fee

Cabco

Ned and Sue decide to sell 50% of non-voting stock to children's DGTs, and 50% of non-voting stock to Ned and Sue's DGTs.

Sales are all at full FMV of the shares sold. An independent appraisal/valuation of the shares is required for the determination of the purchase price.

Shares are sold to the DGTs for installment notes payable by the trusts, with interest, collateralized by the purchased shares.

Cabco

Resulting Ownership		
Ned and Sue	Voting Stock	100,000 shares
Mort DGT	Non-voting stock	150,000 shares
Nort DGT	Non-voting stock	150,000 shares
Sally DGT	Non-voting Stock	150,000 shares
Ned DGT	Non-voting Stock	225,000 shares
Sue DGT	Non-voting Stock	225,000 shares

Cabco
Installment Sale Notes

Transfer Date:	February 21, 2017
Note Term:	9 years
Interest:	Current midterm AFR 2.10%

	Mort DGT	Nort DGT	Sally DGT	Ned DGT	Sue DGT
Underlying Asset Value	$1,500,000	$1,500,000	$1,500,000	$2,250,000	$2,250,000
FMV (30% discount)	$450,000	$ 450,000	$ 450,000	$675,000	$675,000
Sale Price	$1,050,000	$1,050,000	$1,050,000	$1,575,000	$1,575,000

All five trusts are designed to be excluded from Ned and Sue's estates for federal estate tax purposes.

Sales at full FMV at sale date to the three children's DGTs and to Ned and Sue's DGTs would not result in any income tax on the sales and no gift tax consequence to Ned and Sue. Future appreciation in value of the shares shifts` to the trusts.

Fort Worth Plant, Ltd.

Ned and Sue decide to sell 50% of their limited partnership interest to children's DGTs and 50% to Ned and Sue's DGTs.

Sales must be at full FMV of the limited partnership interests sold. An independent appraisal/valuation of the blocks of limited partnership interests to be sold is required for the determination of the purchase price.

Shares are sold to the DGTs for installment notes payable by the trusts, with interest, collateralized by the purchased limited partnership interests.

Fort Worth Plant, Ltd.

Resulting Ownership		
LLC	0%	GP
Mort DGT	16.66%	LP
Nort DGT	16.66%	LP
Sally DGT	16.66%	LP
Ned DGT	25%	LP
Sue DGT	25%	LP

Fort Worth Plant, Ltd.
Installment Sale Notes

Transfer Date: February 21, 2017
Note Term: 9 years
Interest: Current midterm AFR 2.10%

	Mort DGT	Nort DGT	Sally DGT	Ned DGT	Sue DGT
Underlying Asset Value	$1,000,000	$1,000,000	$1,000,000	$1,500,000	$1,500,000
FMV (40% discount)	$400,000	$400,000	$400,000	$600,000	$600,000
Sale Price	$600,000	$600,000	$600,000	$900,000	$900,000

All five trusts are designed to be excluded from Ned and Sue's estates for federal estate tax purposes.

Sales at full FMV at sale date to the three children's DGTs and to Ned and Sue's DGTs would not result in any income tax on the sales and no gift tax consequence to Ned and Sue. Future appreciation in value of the shares shifts to the trusts.

Implemented Planning Result at Second Death

Ned and Sue		
Gross Estate	$16,100,000	
Federal Estate Tax	<2,048,000>	
Net to Children (interests)		$14,052,000
Plus: ILIT (interests):		4,000,000
Plus: Net underlying equity in five DGTs		5,100,000
TOTAL:		$23,152,000

Child Shares Before Any Adjustments

Active Children	Non-Active Children
Cabco	Fort Worth Plant, Ltd.
	Planco
	Cash
	Portfolio

To help equalize:

*Ned and Sue may apportion estate tax to the active children and away from non-active children

*Ned and Sue may allocate their GST Trusts, ILIT and DGTs unequally to take into account value of Cabco passing in greater portion to active children.

Buy - Sell Agreements

A Buy-Sell Agreement is put in place on shareholders of Planco, Inc. to limit the identity of shareholders and provide agreed buyouts on listed “trigger” events:

1.	Death	Mandatory buyout
2.	Disability	Option
3.	Death of a Spouse	Options
4.	Divorce	Options
5.	Bankruptcy	Options
6.	Transfers to third parties	Right of first refusal

Other Provisions:

1. Price
2. Down payment
3. Terms of payment on balance
   (promissory note; installment payment requirements; interest rate; collateralization with purchased shares).

Funding: Consider life insurance to fund death buyout

Alternative Structures of Buy-Sell:

1. Entity redemption; or
2. Cross purchase agreement between shareholders.

Key Management Benefit Alternatives

Below are described alternatives that will be helpful in attracting, motivating and retaining key non-family member employees for a family business.

1. Phantom Stock/Stock Equivalency / Stock Appreciation Rights Plan - A Phantom Stock or Stock Equivalency Plan is a non-qualified deferred compensation contract under which the services to the business by the key employee are rewarded with a business promise to pay the equivalent in value of a predetermined equity interest in the business, including future profit distributions related to such equity interest. This plan allows the key employee compatible economics with stock ownership in the business. Potential tax differences between the capital gain rate (that would be available upon sale of company stock) and ordinary income rates (that are applicable under a Stock Equivalency Plan) can be accounted for in the overall economics of the plan.
2. Employment and Severance Pay Agreement - This is an agreement between the key employee and the business that provides compensation and bonus amounts in substitution for company stock. It is also a deferred compensation contract providing severance pay amounts if the key employee leaves the business for any reason. This option offers similar economics to the Phantom Stock/Stock Equivalency Plan; however, the return to the key employee is keyed to his or her performance or performance of the segment of the business in which the key employee is directly involved. Therefore, because this option is key employee performance oriented, its economics are not related to company valuation increases that are driven by asset appreciation and overall goodwill enhancement of the business.

Although we prefer the above two alternatives over other options, there are other alternatives.

3. Incentive Stock Option - This alternative is the right of the key employee to purchase stock in the business if certain requirements (including federal tax statute requirements) of the ISO Plan are met. While its structured nature and advantageous tax benefits to the key employee have certain attractions, it is the least attractive of the options to the business because it allows no opportunity for company income tax deduction of that which is provided to the key employee.
4. Non-Qualified §83 Stock Option - This option also provides the key employee the right to purchase stock in the business if certain requirements of the plan are met. It is attractive to both the key employee and the company from the income tax standpoint because it is income tax deductible to the business and income tax includable to the key employee when the option becomes irrevocable to the key employee and the option is either exercised or has a reasonably ascertainable value.
5. Restricted Stock This alternative provides for the issuance of stock in the business to the key employee, subject to being forfeited to the company if certain future contingencies occur. It may be viewed as unattractive to the key employee because of its forfeiture aspects. Because it may not be motivational to the key employee to be provided stock in the business with the possibility of future forfeiture, its attraction has limitations to the business.
6. Voting Stock/Non-Voting Stock - This alternative provides an equity interest to the key employee in the business and is unattractive to the business for that reason. In this mobile and easily fractured society, we believe a family business should be maintained within the family (unless or until it is decided to take it public). Because of the opportunity for economic parity offered by the Phantom Stock/Stock Equivalency Plan and the Employment and Severance Pay Agreement alternatives, we believe there is sufficient latitude to provide fair return to the key employee while maintaining the integrity of family ownership in the business.

Expansion of Alternative 1

Phantom Stock/Stock Equivalency Plan

A phantom stock or stock equivalency plan is a non-qualified deferred compensation contract under which the services to the business by the key employee are rewarded with a business promise to pay the equivalent in value of a pre-determined equity interest in the business, including future profit distributions related to such an equity interest.

Business

Advantages

1. The key employee has no equity interest in the business.
2. The business has no cash flow requirements while phantom stock rights are being earned.
3. When the phantom stock rights are paid for at death, retirement, etc., the cost is income tax deductible to the business.
4. The full range of family estate planning options remain available for the family as to the business stock.
5. Key employee leaving employ of the business does not affect business stock ownership. The family keeps the business ownership as has been pre-determined in the family business succession plan.
6. The key employee has a financial interest in the future growth of the business, a "Golden Handcuff," and therefore a strong incentive to work hard and stay with the business.
7. The plan is simple, requiring only a contractual agreement and directors' resolution, without the worry of regulatory restrictions for discrimination as to its selectiveness.

Disadvantages

1. The contribution of the key employee to the increase in value of the business is not necessarily directly related to the increase in value of his benefit under this deferred compensation plan.
2. Future payments to the key employee, at death, retirement, etc., while income tax deductible to the business when paid, are a drain on the cash flow of the business at that time.

Key Employee

Advantages

1. Key employee leaving employ of business does not diminish the value of his plan benefits.
2. The key employee has a financial interest in the future growth of the business and will be accumulating wealth as the company grows in value
3. No discounting of value normally associated with minority equity interest in the business affects the value of the plan benefits of the key employee
4. There are no income tax consequences to the key employee until the rights are paid for at retirement, death, etc.
5. There is no cash outlay, tax or otherwise, by the key employee to gain the benefit unless it is in substitution for bonus or other current benefit.

Disadvantages

1. With no equity interest in the business, the key employee has no vote on business matters.
2. When paid, the plan benefits are income taxable at ordinary income rates. Because the capital gain rate is lower, this means more income tax will be paid by the key employee than would be paid if he owned and sold stock in the business. This can be addressed by the business agreeing to pay the key employee more because the capital gain rate is lower.
3. Key employee must have cash to pay the income tax when due.

Expansion of Alternative 2

Employment and Severance Pay Agreement

This is an agreement between the key employee and the business that provides compensation and bonus amounts in substitution for business stock. It is also a deferred compensation contract providing severance pay amounts if the key employee leaves the business for any reason.

Business

Advantages

1. The key employee does not have an ownership interest in the business. Upon leaving the business, for whatever reason, the ownership of the business stays as pre-determined under the family's succession plan.
2. Payments to key employee are income tax deductible to the business when paid at death, retirement, etc.
3. Significant flexibility in the various types of benefits that can be provided the key employee, including unfunded deferred compensation, salary continuation, death benefit only for his family.
4. Key employee reward can be tied to his performance or the performance of the particular segment of the business that the key employee specifically impacts, and therefore a strong incentive to work hard and stay with the business. If compensation is to be performance based, employee should have some input concerning business decisions that impact his performance areas or the criteria by which his performance is measured should not be able to be changed by the business owners without his agreement.
5. The full range of family estate planning options remain available to the family as to the business stock.
6. The plan is simple, requiring only a contractual agreement and directors' resolution, without the worry of regulatory restrictions for discrimination as to its selectiveness.

Disadvantages

1. Current and future compensation, bonus and severance payments, while income tax deductible to the business when paid, are a drain on the cash flow of the business at that time.

Key Employee

Advantages

1. Reward for the key employee's labor is not eliminated upon leaving the business.
2. Significant flexibility in the various types of benefits that can be provided the key employee, including unfunded deferred compensation, salary continuation, death benefit only for his family.
3. Key employee reward can be tied to his performance, or the performance of the particular segment of the business that the key employee specifically impacts. If compensation is to be performance based, employee should have some input concerning, business decisions that impact his performance areas or the criteria by which his performance is measured should not be able to be changed by the business owners without his agreement.
4. There are no income tax consequences to the key employee until the rights are paid for at retirement, death, etc.
5. 5. There is no cash outlay by the key employee to gain the benefit.

Disadvantages

1. The payments are income taxable to the key employee at ordinary income tax rates (a disadvantage because capital gain rate is lower). This can be addressed by the business agreeing to pay the key employee more because the capital gain rate is lower.
2. Key employee must have cash to pay the income taxes when due.
3. With no equity interest in the business, the key employee has no vote on business matters.

Expansion of Alternative 3

Incentive Stock Option

This is a right to purchase voting or non-voting stock in the business. To qualify as an incentive stock option, the plan must satisfy, among other requirements, the following:

1. Option must be granted in connection with employment;
2. Option must be granted pursuant to a plan approved by shareholders within 12 months before or after date of plan adoption;
3. All options under plan must be granted within 10 years of plan adoption;
4. Options must be exercisable within 10 years (5 years if key employee owns 10% of stock at time option is granted) from their date of grant;
5. Option price cannot be less than fair market value of stock at time option granted;
6. Key employee, when option granted, cannot own more than 10% of the business (this provision is waived if option price is 110% of fair market value and there is only a 5 year option period);
7. Aggregate value of stock which key employee can acquire by exercise of stock option for the first time during a calendar year cannot exceed $100,000 per annum determined as of date option first exercisable.

If desired, it can be granted based upon satisfying certain predetermined performance objectives required of the key employee or the business.

Business

Advantages

1. Does not adversely affect cash flow of business upon grant of stock option to the key employee.
2. 2. Upon exercise of the option and purchase of stock, cash will come into the business in the amount of the option price of the stock.
3. 3. If desired, issue of stock option in lieu of other compensation to the key employee can reduce the compensation that otherwise would be paid the key employee for his efforts in the business.
4. 4. Performance objectives can be structured to give the business greater assurances of the key employee continuing as a productive member of the business.

Disadvantages

1. If performance objectives are met, then it puts the key employee as an owner of business. A Buy-Sell Agreement with the key employee can diminish this problem by providing for stock buy out under certain circumstances, including termination of employment.
2. No income tax deduction to the business is allowed upon either the grant, exercise of option or sale of stock.

Key Employee

Advantages

1. When the performance objectives are fulfilled, the key employee can purchase an equity interest in the business and share in its future value increase. A Buy-Sell Agreement can provide security for receipt of the key employee investment if he is no longer in the business.
2. If the key employee exercises the option while an employee, or within three (3) months after termination of employment, and does not dispose of the stock during the required statutory holding period, there is no income taxation upon grant or exercise of option; income tax is deferred until sale of stock. Upon later sale of stock, buy out of the key employee's stock will be at capital gain rate.

Disadvantages

1. Key employee ownership will probably be a minority interest in the business. Therefore, the key employee's impact on the decision making of the business will be minimal.
2. When the stock option is exercised, the key employee must have the cash to purchase the business stock.
3. Without provision made in a Buy-Sell Agreement, there is little market for the key employee's minority stock interest in the business upon death, disability, retirement or termination of employment with business.
4. Without provision made in a Buy-Sell Agreement, the lack of marketability of the key employee's stock causes the value to be discounted.

Expansion of Alternative 4

Non-Qualified §83 Stock Option

This is a right to purchase voting or non-voting stock in the business. If desired, it can be granted based upon satisfying certain pre-determined performance objectives required of the key employee.

Business

Advantages

1. Does not adversely affect cash flow of business upon grant of stock option to the key employee.
2. Upon exercise of option and purchase of stock, cash will come into the business in the amount of the option price of the stock.
3. Issue of stock in lieu of other compensation to key employee may reduce the compensation that otherwise would be paid the key employee for his efforts in the business.
4. Performance objectives can be structured to give the business greater assurances of the key employee continuing as a productive member of the business.
5. 5. When the performance objectives or other restrictions to the exercise of the stock option are met, the business is allowed an income tax deduction in an amount that equals the difference between the stock's option (purchase) price and the stock's fair market value (if the stock option has been exercised).

Disadvantages

1. When performance objectives or other restrictions are met, the key employee exercises his stock option and becomes an owner of the business, he will continue as an employee of the business. A Buy-Sell Agreement with key employee can diminish this problem by providing for stock buy out under such circumstances.

Key Employee

Advantages

1. When the performance objectives or restrictions are met, the key employee can purchase an equity interest in the business and share in its future value increase. A Buy-Sell Agreement can provide security for receipt of the key employee investment if he is no longer in the business.
2. Buy out of the key employee's stock will be at capital gain rate which could provide an income tax advantage.

Disadvantages

1. Key employee ownership will probably be a minority interest in the business. Therefore, the key employee's vote and impact on the decision making of the business will be minimal.
2. When the performance objectives or other restrictions to the exercise of the stock option are met, the key employee has taxable income in an amount that equals the difference between the stock's option (purchase) price and the stock's fair market value if the option has been exercised, or in an amount that equals the value of the stock option if it has not been exercised but has a value that is reasonably ascertainable. Key employee must have cash to pay the income tax. When the stock option is exercised, the key employee must have the cash to purchase the business stock.
3. Without provision made in a Buy-Sell Agreement, there is little market for the key employee's minority stock interest in the business upon death, disability, retirement or termination of employment with the business.
4. Without provision made in a Buy-Sell Agreement, the lack of marketability of the key employee's stock causes the value to be discounted.

Expansion of Alternative 5

Restricted Stock

This is the issuance of stock in the key business to key employee subject to certain risks of forfeiture of the stock. The stock can be either voting or non-voting, stock. The right to acquire the stock is restricted in that it is subject to what the law defines as substantial risks of forfeiture.

Business

Advantages

1. Does not adversely affect cash flow of business upon issue of stock to key employee.
2. If purchased, upon issue will result in cash coming into the business in the amount of the purchase price of the stock.
3. If issued as bonus in lieu of other compensation to key employee, may reduce the compensation that otherwise would be paid the key employee for his efforts in the business.
4. Risk of forfeiture of stock of key employee can be structured to give the business greater assurances of the key employee continuing as a productive member of business.
5. If the restricted stock is issued as a bonus to the employee when the substantial risks of forfeiture of the stock are removed or the stock becomes transferable, the business is allowed an income tax deduction in an amount equal to the value of the stock at that time.

Disadvantages

1. When the stock is issued, the key employee immediately becomes an owner of business and will continue as such irrespective of his continuing as an employee of the business. A Buy-Sell Agreement with key employee can diminish this problem by providing for stock buy out under such circumstances.

Key Employee

Advantages

1. The key employee owns an equity interest in the business upon stock issuance and will share in the future value increase of the business. A Buy-Sell Agreement can provide security for receipt of the key employee investment if he is no longer in the business.
2. Buy out of the key employee's stock will be a capital gain rate which could provide an income tax advantage.

Disadvantages

1. Key employee ownership will probably be a minority interest in the business. Therefore, the key employee's vote and impact on the decision making of the business will be minimal.
2. The key employee may lose the stock if the substantial risks of forfeiture are not removed.
3. If restricted stock is issued as a bonus to the key employee, when the substantial risks of forfeiture are removed or the stock becomes transferable, the then value of the stock is income taxable to the key employee and key employee must have cash to pay the tax. If, however, a special election is made by the key employee under §83(b), the value of the stock will be included in the key employee's gross income in the year the stock was transferred to the key employee.
4. Without provision made in a Buy-Sell Agreement, there is little market for the key employee's minority stock interest in the business upon death, disability, retirement or termination of business.
5. Without provision made in a Buy-Sell Agreement, the lack of marketability of the key employee's stock causes the value to be discounted.

Expansion of Alternative 6

Voting Stock

Voting stock gives the key employee an equity interest in the business corporation and its future increase in value. This equity interest includes the voting, rights associated with business ownership.

Business

Advantages

1. Does not adversely affect cash flow of business upon issue of stock to key employee.
2. If stock is purchased, it will result in cash coming into the business in the amount of the purchase price of the stock.
3. If stock is issued as employee bonus, compensation may be reduced that otherwise would be paid the key employee for his efforts in the business.
4. Equity ownership of key employee in business should increase his sense of enterprise and effort concerning the business because he directly shares investment risk with other business owners.
5. If the stock is issued as compensation, an amount equal to the value of the stock is income tax deductible to the business when issued unless stock is subject to a "substantial risk of forfeiture" under §83.

Disadvantages

1. The key employee becomes an owner of the business irrespective of his continuing as an employee of the business. A Buy-Sell Agreement with the key employee can diminish this problem by providing for stock buy out under such circumstances. A Voting Agreement or Voting Trust can be used to provide control on the key employee's business stock ownership while owned by the key employee.
2. Buy out of a key employee's stock in the business will be with non-income tax deductible dollars of the business (i.e., after tax dollars).
3. May result in imbalance of voting control at second and third family generation levels.

Key Employee

Advantages

1. The key employee owns an equity interest in the business and will share in the future value increase of the business. A Buy-Sell Agreement can provide security for receipt of the key employee's investment if he is no longer an employee in the business.
2. Buy out of the key employee's stock will be at capital gain rate.

Disadvantages

1. Key employee's ownership will probably be a minority interest in the business. Therefore, the key employee's vote and impact on the decision making of the business will be minimal.
2. If the stock is issued as a bonus, it will be income taxable to key employee when received and he must have the cash to pay the income tax.
3. Key employee must have cash at time stock issued to pay for stock if he purchases it.
4. Without provision made in a Buy-Sell Agreement, there is little market for the key employee's minority stock interest in the business upon death, disability, retirement or termination of employment with business.
5. Without provision made in a Buy-Sell Agreement, the lack of marketability of the key employee's stock causes the value to be discounted.