

Strategic Insights

From Entrepreneur to Investor:
Successfully Navigating the Transition



BNY MELLON
WEALTH MANAGEMENT

From Entrepreneur to Investor

Owning and running a thriving business is akin to having a successful long-term relationship. It is all consuming, and requires energy, passion, and commitment. At some point, however, that relationship will end — the business owner will sell the business, close the business, or transfer the business to family. The termination of this relationship is one that must be carefully considered well in advance of the event.

The Decision

The decision to close the doors of the business may be an easy one, informed largely by economics. The decision to sell the business outright, or transfer it to family members, however, typically is far more complicated, involving consideration of myriad financial, familial and emotional factors. Once that decision is made, the impulse is to move quickly into action: if the decision is to sell, then a deal is struck; if the decision is to keep the business in the family, then business interests are transferred. Business owners should resist the urge for swift action, however. Instead, the business owner should proceed slowly and judiciously, taking care to make sure that both the “deal” and the family financial structure are in place well in advance of any change in ownership. Additionally, a business owner should carefully consider the lifestyle and psychological changes that accompany the move from entrepreneur to investor.

The factors informing the decision to sell a business or keep it in the family fall roughly into two categories: the hard facts and the softer factors. The hard facts include issues such as: market conditions, stage of business lifecycle, economic conditions, opportunities for organic vs. acquisition growth, foreign competition, and a litany of other business indicators. These factors are relatively easy to divine.

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More difficult is the task of sifting through the fuzzier considerations. These less tangible inputs might include certain characteristics or life stages assignable to the business owner — changing appetite for risk, energy and enthusiasm for running the business, desire to pursue other interests, and compulsion to retain control of the business. Those factors involve introspection, which is a difficult task for most of us. Some of the other soft factors include examination of other individuals, which can be even more difficult than introspection, especially when those individuals are family members or trusted employees. The business owner must consider the business aspirations and aptitudes of the children, the nature of the relationship among the children and the impact that would have on the business, and the nature of the business owner's relationship with his or her children. Likewise, the entrepreneur must consider the likelihood that the business will remain a viable venture if left in the hands of existing management and leadership.

Dealings Before the Deal

Building the Right Team

Once these numerous factors have been considered and a decision has been reached, the business owner enters a critical phase of information gathering and planning. At this point, acting too hastily can easily derail the transaction. Common missteps include flawed notions of business value or sale proceeds, insufficient allocation of resources to the transaction process, unsubstantiated projections, inadequate due diligence, inability to juggle the demands of the transaction with the ongoing requirements of the business, and failure to assemble a complete team of appropriate advisors.

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Regardless of the industry or type of business, a business owner will need a common core of advisors when the decision is made to sell or transfer a business. The advisor dream team likely will include an investment banker, an accountant familiar with corporate and personal taxes, an attorney familiar with business law issues and wealth transfer matters, a business valuation specialist, and a wealth manager.

Assembling this team can be a challenging undertaking. Often, the first impulse is to engage the advisors who have been helping the business since its inception. Sometimes this can be exactly the right decision. The danger, however, is that, as the business, the family, and the wealth have grown, the complexities of that business and the nuances around the transfer of that business may exceed the capabilities of long-standing advisors. Prudent advisors who recognize this will be candid with the business owner about the situation, and will work to

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stay involved in the business while also referring the owner to a specialist. It is important to remember that bringing in a specialist does not necessitate the end of a long relationship with an advisor. In addition to advisor referrals, personal networks, such as other business owners, are a valuable resource for referrals to qualified and specialized advisors. Of course, businesses in certain industries might require additional industry-specific assistance. Peer networks, trade associations and professional groups can be enormously helpful in identifying the need for specialized advice and finding the appropriate advisors.

Once the right team is assembled, it is up to the business owner to oversee the activities of the advisors, which begins with drafting a timeline and order of activities. Before discussions of the deal begin, however, the business owner must consider his or her own family financial dealings.

Assessing Family Financial Goals

Independent of any discussion about an anticipated deal for the business, the business owner and his or her family must consider how they would like their family's wealth to work for them. This discussion can be framed around one deceptively simple question, "How much is enough?"

Three questions comprise this one question:

1. How much is enough for my spouse and me (i.e., spending)?
2. How much is enough for my family (i.e., inheritance)?
3. How much is enough for my community (i.e., philanthropy)?

The answers to these questions will drive the family's wealth management strategy and, in turn, impact the form of the business deal or transfer. For example, if charitable giving is a priority, a stock transaction might be more beneficial than a cash deal.

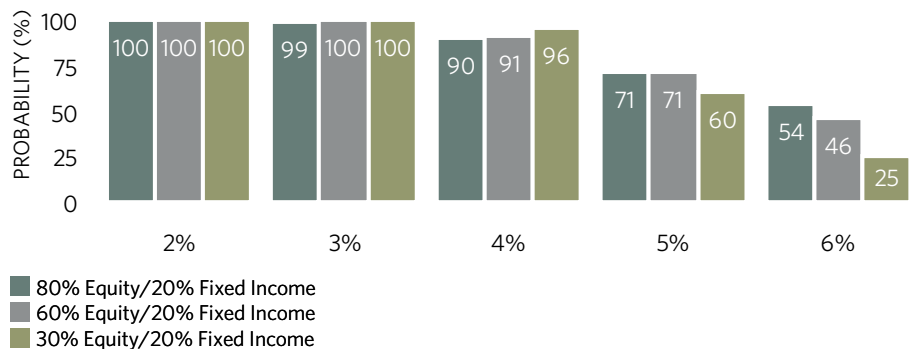
How Much Is Enough: Forecasting Your Spending Needs

Determining how to pay for a certain lifestyle after the sale of a business can be a huge challenge for entrepreneurs. Many business owners are able to finance their lifestyle out of cash flow from the business. Upon the sale of the business, however, that cash flow dries up and the former business owner will have to rely upon the proceeds of the sale to finance his or her lifestyle. The analysis of what type of lifestyle those proceeds can support is often an eye-opening and sometimes unsettling experience.

Exhibit 1

Impact of Spending Rate on Portfolio Value

Probability of Assets Greater than %0 after 30 Years



Spending rate equals stated percentage of incetion market value and increases at an assumed inflation rate of 2.5% per annum. Asset allocations are constructed based on current BNY Mellon Wealth Management's strategy recommendations. Return assumptions: 9% Large Cap; 10% Small Cap; 8.5% International; 6.5% Taxable Bonds; 4.5% Tax-Exempt Bonds; 3.5% Cash; 12% Emerging Markets; 13% Private Equity; 9.5% Mid Cap; 8.5% Hedge.

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Prepare the Money for the Family, and Prepare the Family for the Money

Once the discussion of “how much is enough” is underway, discussions of family wealth strategies often begin to focus on tactics for passing wealth in the most tax-efficient manner possible. Often, as a result, little consideration is given to ensuring that the children and grandchildren, who will be the beneficiaries of the family wealth, are prepared to handle it. One need not search very far in the popular press to find stories of families in which wealth has proven crippling to younger generations rather than providing opportunities. Any complete plan for family wealth management must address issues of wealth education and stewardship, and the impact that the wealth management strategy will have on the family.

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One family wealth issue that arises frequently in the context of a family business is the challenge of equalization. How can a business owner, from a financial perspective, treat one child who is active in the family business equal to another child who has no interest in the business? Is it really necessary or appropriate to achieve equality? There are no absolute answers to these questions, but failing to address them can be a significant impediment to passing family wealth and promoting family harmony.

Transferring Assets

Once the family wealth management strategy has been determined, the next step is to identify the appropriate techniques to carry out the family’s goals. These techniques are created, at least in part, to mitigate taxes. When transferring assets, the transferor must contend not only with the Federal estate tax, which is a tax on the value of assets transferred at death, but also the Federal gift tax, which is a tax on the value of assets transferred during the transferer’s life. (Gift and estate taxes will be referred to herein as transfer taxes.)

The techniques for transferring assets generally can be classified as family transfers and charitable transfers. The timing of the transfers will differ between these two groups. Generally, transfers to family members should be made well in advance of any business transaction, when valuations of the business interest are low. The lower valuation allows for the transfer of greater interests with lower transfer tax impact. On the other hand, for transfers to charity, the transferring business owner would prefer to have the highest valuation possible in order to receive the maximum charitable income tax deduction. Accordingly, charitable transfers generally are made at a time close to the transaction date, where there is an increase in value. The discussion that follows illustrates these points, and also highlights circumstances in which these general rules are subject to exceptions.

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Transferring Assets in the Family

The techniques available to transfer assets within the family in the most transfer-tax-efficient manner fall roughly into four categories:

- Outright gifts
- Discounted gifts
- Gifts in trust
- Sales

Keep in mind that what follows is a broad overview of some quite complicated techniques. Any technique of interest should be discussed in greater detail with the appropriate tax or legal counsel.

Outright Gifts

An outright gift is a direct transfer of some or all of a transferor's interest, unencumbered by any other entity. For example, Bob owns all of the 100 outstanding shares of stock in Happy Day Baby Food, Inc, and Bob decides to give 40 shares to his son. The stock is worth \$10,000 per share. After the gift, Bob's son owns those shares in his name and has full control over them. The outright gift is attractive for its simplicity, but likely will not afford as wide an array of discounted valuation opportunities as do other techniques.

Discounted Gifts

By simply transferring shares of the business to another entity and gifting interests in that new entity, the business owner might be able to take advantage of more significant valuation discounts. Consider Bob again, and assume that Bob decides to contribute all of his Happy Day shares to a family limited partnership (FLP) and takes, in return, a 1% general partner (GP) interest, and a 99% limited partner (LP) interest. Further assume that Bob gives a 40% LP interest to his son. As GP, Bob maintains control over the stock owned by the FLP and, as a LP, Bob's son has no control over the FLP assets, but is the owner of the wealth represented by his LP interests. The result is a shifting of wealth from Bob to his son, but with Bob retaining control.

Placing the stock in the FLP "wrapper" creates opportunities for valuation discounts.

In addition, the FLP might herald transfer tax savings. If based solely on the underlying assets, the value of the gift, for transfer tax purposes, would be \$400,000. Placing the stock in the FLP "wrapper," however, creates opportunities for valuation discounts, including lack of marketability discounts and minority interest discounts. In the above situation, if Bob were successful in establishing a 35-40% valuation discount, the value of the transfer, for tax purposes, would be \$240,000. This technique particularly is effective when timed correctly and used with an asset that is anticipated to appreciate rapidly. In Bob's case, the perfect scenario would be for Bob to create the FLP with his stock well in advance of any Happy Day transaction, and then at some point after the transfer of the LP interests, create an event that causes appreciation (e.g., sale or IPO). In that case, the value of the wealth transferred would be based on a low stock price and would include multiple discounts. The future appreciation would not be included in Bob's estate, but would be in his son's.

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A word of caution is appropriate here — the valuations available through the use of a FLP or similar tool, such as a limited liability company (LLC), are incredibly fact intensive and will vary from case to case. The IRS has been directing increased attention to these entities, and additional attention from the IRS is rarely positive. FLPs and LLCs continue to be viable wealth transfer techniques, but any business owner considering them must be working with sophisticated advisors, must honor the formalities and structural requirements of the entity, and must be aware of the IRS's attention to this issue.

Gifts in Trust

Creating trusts and funding them with business interests also can have tremendous transfer-tax advantages. The most basic type of trust planning involves transferring assets to an irrevocable trust for the benefit of a group of beneficiaries. Bob might create an irrevocable trust for the benefit of his sons and fund the trust with shares of Happy Day. The trust could be drafted to meet Bob's wealth transfer goals. For example, the trust might direct

that the sons get all income from the trust assets and have the ability to receive distributions of principal for certain needs, such as education, starting a business, or buying a home. The trustee of the trust controls the trust assets, and, in Bob's case, the trustee would also have control of the trust's Happy Day shares. This may provide an opportunity to grant some control of the business to Bob's children, by making them co-trustees. Alternatively, Bob could name a trusted advisor as trustee, effectively providing Bob's children with the benefit of the Happy Day shares but not affording them control. The issue of trustee selection is critically important, immensely technical, and can dramatically impact the management of the shares within the trust. For this reason, any business owner engaging in trust planning must think carefully with his or her advisors about the range of possible trustees.

Trust planning should be undertaken well in advance of any event that would increase the value of the interests transferred, such as an IPO or sale.

The tax advantage derived from trust planning is realized when the trust creator, also known as the grantor, shifts assets out of his or her estate into a trust. In Bob's case, he has moved shares of Happy Day from his estate into the trust. Because that transfer is taxable for gift tax purposes, the transfer is most effective when done when the interests have the lowest possible valuation. Therefore, trust planning should be undertaken well in advance of any event that would increase the value of the interests transferred, such as an IPO or sale.

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Dynasty Trust

A specific variation on the general trust planning theme is a Dynasty Trust, so named because these trusts have the potential to last forever. For many years, trusts were subject to arcane laws that limited their duration; generally, trusts could last for about 100 years. In the recent past, certain states have passed laws that allow trusts to have perpetual life, hence the Dynasty Trust moniker. While a number of states have such legislation, perhaps best known is Delaware, which is characterized by a body of well-developed trust laws. If structured correctly, a Dynasty Trust will allow the grantor to transfer assets into the trust, and those assets can remain in trust for many generations, insulated from state income and estate taxes. Dynasty Trust planning can have a remarkable impact on a family's long-term wealth. For example:

Exhibit 2

Dynasty Trust Planning

Comparison of Wealth Available to Future Generations

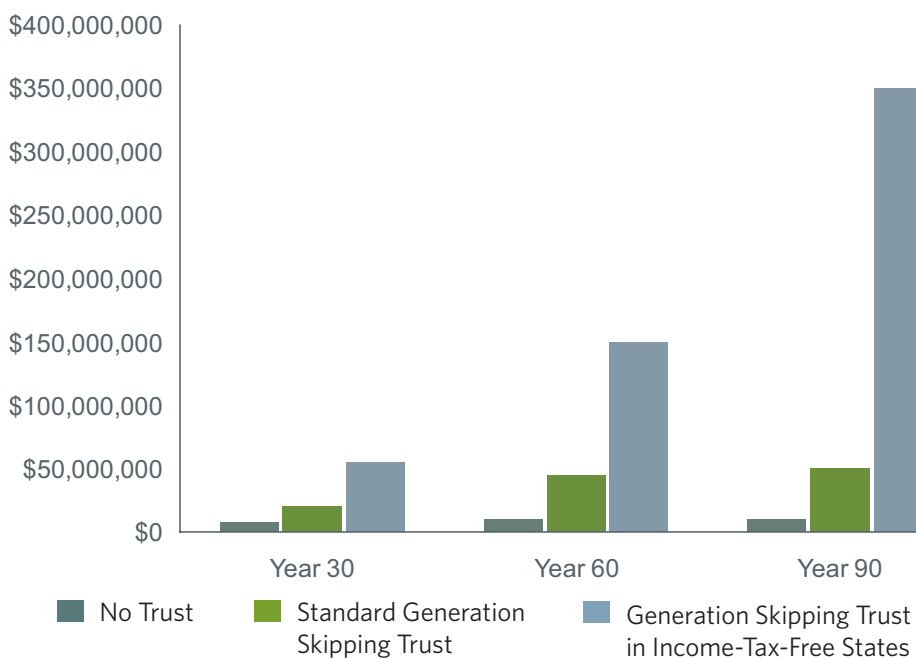


Exhibit 2 illustrates another key point in trust planning, which has to do with income taxes. A funded trust is a taxpayer, and trust assets are subject to income tax. The taxation of trust assets, however, varies from state to state. Some states subject trust assets to the same taxes to which an individual taxpayer would be subjected; at the other end of the spectrum are states that do not tax trust assets. These income-tax-free states allow the tax-free growth that makes the results illustrated in the graph so dramatic. The varying tax treatment from state to state is just one reason that the selection of controlling state law, or trust situs, is so critically important. Selection of the correct situs must include analysis of the character and location of trustees, beneficiaries, grantors, and trust assets, but the result of that analysis can significantly benefit future generations of beneficiaries.

Grantor Retained Annuity Trust

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The grantor retained annuity trust (GRAT) is an advanced trust technique that allows for leveraged gifting due to a disparity between assumed growth rates in the economy and expected asset-specific growth rates. A GRAT is a wealth transfer technique that allows the shifting of wealth in a tax-efficient manner. The GRAT basics are:

- Business owner creates a GRAT specifying how long the GRAT will last, how much an annuity payment he or she will obtain from the trust, and what will happen to the trust assets upon termination of the GRAT;
- Business owner funds the GRAT with company stock, hopefully in contemplation of rapid growth of the stock value;
- Upon funding the GRAT, the IRS looks at the size and duration of the annuity the GRAT will pay to the business owner, as well as the prevailing interest rates (known as the Applicable Federal Rate) at the time of the transfer, and determines what the remainder will be in the GRAT at the point of termination;
- Finally, the IRS determines the value transferred for transfer-tax purposes based on the remainder calculated.

At that point, the business owner pays any transfer tax that is due, based on the value of the transfer and the trust begins to operate — the business owner receives the annuity payment, and the trust lives out its term. Once the transfer tax is paid at the initial funding of the trust, there will be no further tax due, regardless of how the trust assets perform. The tax efficiency, therefore, is achieved if the asset contributed to the trust grows at a rate faster than the Applicable Federal Rate. In that case, the trust will have more assets upon its termination than was projected by the IRS, and that excess amount is essentially a transfer-tax-free gift.

For example, assume that Bob creates a GRAT and funds it with Happy Day stock worth \$1 million. The GRAT will last for 10 years, and Bob will receive an annual payment from the GRAT of \$129,505 for each of the 10 years. The IRS would look at the term of the trust, the amount contributed, the amount of the payments, and the prevailing interest rate, which is a proxy for the rate the assets will grow inside the GRAT. For this example, the rate applied is 5%. Given all of these inputs, the IRS will determine that at the termination of the GRAT, there will be no assets left to pass to the beneficiaries or, in this case, Bob's children. As such, Bob has made no gift in the eyes of the IRS, and all gift tax matters with regard to this trust have been settled. If the Happy Day stock actually does grow at 5% each year, there will be nothing left for Bob's kids at the end of the GRAT term. If, however, Happy Day experiences some appreciation event during the GRAT term and grows at 15% per annum, \$1,400,000 will pass to Bob's children. In this 15% situation, the original gift tax calculation will apply, in effect allowing \$1.4 million to transfer from Bob to his children, free of gift tax. The general rule is that a GRAT will be a successful wealth transfer technique if the growth rate of the GRAT assets exceeds the rate assumed by the IRS. At the time of this writing, prevailing low interest rates make GRATs particularly attractive planning tools.

Generally, a GRAT will be a successful wealth transfer technique if the growth rate of the GRAT assets exceeds the rate assumed by the IRS.

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The GRAT is useful for a business owner who wishes to transfer business interests to his or her family at a point prior to some event that will cause rapid appreciation. Contributing company stock to a GRAT in advance of a sale of the business is an ideal use of the technique.

At the time the GRAT is created, the business owner has many options as to the disposition of the assets upon the termination of the GRAT. The GRAT document may direct that the assets pass outright to the children of the business owner, or could direct the assets into follow-on trusts that would provide for the children's benefit. Obviously, if the GRAT assets were to pass outright to the children, then the children would control those assets and, in the case of company stock, would be able to vote those shares. If the assets were to pass to a follow-on trust, the trustee of that trust would control the assets, which might afford some opportunities to appoint a business colleague to oversee business assets owned by the trust. Providing for grandchildren and more distant generations through a GRAT can be a challenge due to technical rules surrounding the generation skipping tax (GST), which is yet another transfer tax.

Sales

The techniques just described involve the gratuitous transfer of an asset, in other words, a gift. Many business owners decide for one reason or another that they are not in a position to, or inclined to, make a gift of a business interest. In these cases, a sale of some portion of the business interest can be the right technique. The sale of business interests can be as varied in form and shape as the businesses involved, but a few general tools exist.

Outright Sales

One tool is the outright sale — a simple transfer from party A to party B for fair value. If Bob were to sell shares of Happy Day to his son, he would receive payment in return, and Bob's son would own the shares outright. Bob would also be faced with capital gains taxes upon the sale. Were Bob interested in deferring that capital gains tax, he and his son might enter into an installment sale obligation. Under that arrangement, Bob would sell the business interest to his son in year one, but payments would be made to Bob over some term, perhaps a 10-year period. The capital gains bite likely would then be spread over a 10-year period. The installment sale is a basic technique that is popular with many business owners for its simplicity. It is not without technical pitfalls, however, so a business owner must engage appropriate counsel to ensure that the deal is structured correctly. Failure to do so can carry adverse tax consequences.

Intentionally Defective Grantor Trust

Another popular technique is the sale to an intentionally defective grantor trust (IDGT), which involves the sale of business interests to a trust created by the business owner for the benefit of his/her family. An IDGT is an irrevocable trust that is not included in the grantor's estate for estate tax purposes, but the income of which is taxed to the grantor. This taxation structure occurs because the grantor retains certain powers that cause the transfer to be less than total for income tax purposes or, in tax parlance, defective. Typically, a business owner would create the IDGT, fund it with a small amount of liquid assets, and sell business interests to it in return for a note. Other ways to structure the payments from the IDGT to the original business owner include a private annuity or self-cancelling installment note (SCIN). The use of a private annuity or SCIN, however, might bring unfavorable tax consequences to the grantor. The grantor should discuss these issues with his or her tax advisor.

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Once the business interest is sold to the IDGT, the business continues to operate, and hopefully, generates enough cash to pay the debt owed to the grantor. If done correctly, the structure of the payments to the grantor can serve to defer the capital gains recognized by the grantor, as with an installment sale. If the business is sold in the future, the proceeds of the interest owned by the IDGT will be available for its beneficiaries, presumably the family of the business owner.

The fact that the trust's income taxes are the obligation of the grantor offers an additional transfer tax advantage for two reasons: because the grantor is paying the taxes owed by the trust, the growth of the trust assets will be tax-free and should result in a greater amount of assets passing to the IDGT beneficiaries. Also, the payment of the taxes by the grantor is effectively a tax-free gift, thus moving assets out of the grantor's estate with no gift tax cost.

The IDGT allows the business owner to fix the value of the business in his or her estate at the amount of the note between the IDGT and the business owner; no gift tax is due when the business is transferred to the IDGT. If the assets in the IDGT subsequently increase in value, that value will be out of the estate of the grantor. Again, timing of this transfer technique is critical, and shifting interests to an IDGT well in advance of any event that will boost enterprise value will yield the greatest tax benefits. The following example illustrates this technique.

Assume that Bob has \$900,000 of Happy Day stock with a cost basis of \$100,000. Bob creates an IDGT with his children as beneficiaries and his brother/business partner as trustee. Bob makes a gift of \$100,000 cash to the IDGT and sells his stock to the IDGT for a \$900,000 note. The note has a 9-year term, an interest rate of 4.75%, and allows for interest-only payments with a balloon payment at the note's end. If the assets in the IDGT grow at 15%, the children, as beneficiaries, will receive \$1.9 million, and Bob will have converted part of his stock position to cash while using only \$100,000 of his gift tax exemption (or paying gift tax on \$100,000 if his gift tax exemption has been used already). The capital gain on the sale will be deferred until Bob receives the balloon payment. Additionally, Bob's brother, who is very familiar with the business, will control the stock owned in the trust.

Transferring Assets to a Charity

Charitable planning can provide tremendous tax advantages for a business owner who is philanthropically inclined. There are myriad techniques available for transferring assets to charity. Here, we will focus on three primary categories:

- Outright gifts
- Split interest gifts
- Perpetual gifts

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Outright Gift

An outright gift is a transfer to a charity that affords no continued control to the donor. It can be a useful tool for creating deductions and mitigating tax due in the year of a liquidity event for a business owner.

For example, Bob may decide to transfer shares in Happy Day to the local Community Foundation, which is a public charity. Because he is making a gift of stock, Bob would likely get a charitable income tax deduction equal to the fair market value of his gift. Because Bob is interested in maximizing his deduction, he would like to get the greatest valuation possible for the contributed business interests. This is in contrast to the other transfer techniques described above that benefit from a lower valuation. As a result, a transfer of business interests to charity usually is more valuable if made closer to an event that will increase the value of the donated interest. That said, it may be useful for a business owner to contribute business interests to charity well in advance of a transaction in order to help set the value of that asset, which then can be used in justifying the value of transfers to other intra-family wealth transfer instruments such as those previously described.

Split Interest Gifts

Unlike an outright gift, a split interest gift involves more than just the interests of the charitable organization. Two primary types of split interest gifts are available: charitable remainder trusts (CRT) and charitable lead trusts (CLT).

A CRT is an irrevocable trust created by a donor/business owner, which instructs that a certain amount be paid each year to a person or people holding an income interest in the trust. Upon termination of the trust, the amount remaining in the CRT passes to the charity designated by the donor. These payments are made to the individuals for the term of the trust, which can be up to 20 years or a term that extends over one or more person's lifetimes.

Funding a CRT in the year of a liquidity event can mitigate what will likely be a large tax bill.

The CRT has several significant tax advantages. First, the grantor of a CRT will receive a charitable income tax deduction equal to the value that the IRS thinks will ultimately pass to the charitable beneficiary. This deduction is available in the year that the CRT is funded, which means that funding in the year of a liquidity event can mitigate what will likely be a large tax bill. Keep in mind that the type of charity that is the ultimate beneficiary of the CRT assets will have some impact on the deductibility limits for the year of the gift.

The other tax advantage of the CRT is the potential to defer capital gains. If Bob has a very low cost basis in his Happy Day stock, he could contribute it to the CRT. The trustee of the CRT then could sell the Happy Day stock and, because the CRT is tax exempt, no immediate tax impact would occur from that sale. The trustee then could invest the proceeds from the sale in a diversified portfolio that would support the payments to the income beneficiaries.

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The CRT is considered a capital gains tax deferral tool — and not a tax avoidance tool — because the capital gain realized upon the sale of the Happy Day stock still would be held in the CRT and could be distributed out with the payments at some point. The payments from the CRT to individuals generally are taxable to the recipient, and the taxation is dictated by a complicated distribution scheme. Additionally, a CRT generally is not a good tool for holding shares of S-corp stock.

For example, assume that Bob is 65 years old and contributes \$1,000,000 of Happy Day stock to a charitable remainder trust. The CRT will make a payment to him of 5% of the trust assets every year for his life, and, upon his death, will pass the trust assets to Bob's alma mater. Using these facts, and assuming an applicable Federal rate of 4% and a growth rate of 8% in the trust assets, Bob would receive a charitable income tax deduction of \$357,270 in the year he funds the trust. Additionally, over his projected lifetime, Bob would receive payments from the trust totaling more than \$1.5 million, and the charity would receive almost \$1.2 million at trust termination. If Bob's contributed stock was highly appreciated, he would be able to convert that stock into a stream of income without a large immediate capital gains consequence.

The CLT is the opposite of a CRT. A CRT pays income to an individual for some period and then distributes the remainder to a charity; a CLT first makes payments to a charity for some period and then pays out to individual beneficiaries.

A CLT generally operates as follows: a business owner creates a CLT and contributes some business interest. The trust makes annual charitable distributions for a designated period. Upon the trust termination, what is left in the trust passes to the non-charitable beneficiaries. In Bob's case, he would contribute Happy Day stock to a CLT that he has established to last for a 10-year period. For those 10 years, the trust would make annual payments to a charity of 5% of the trust's value. At the end of the 10-year period, whatever is left in the trust would pass to Bob's children.

The CLT can have great transfer tax advantages. That is because the amount of the gift that is subject to gift tax is determined at the time the trust is funded, but the results at the end of the trust might be markedly different. Simply illustrated, assume that Bob contributes \$1,000,000 to a CLT, which will pay 5% of the trust value to charity each year. If the IRS applies a 5% assumed growth rate to CLT assets, \$614,000 of the amount transferred into the trust will be subject to gift tax. At the end of 10 years of 5% growth there will still be \$1,000,000 in the trust that will pass to Bob's heirs. If, however, the CLT assets grow at 10% per year, there will be \$1,630,000 in the trust for Bob's heirs, but the amount of the transfer subject to gift tax will remain fixed at \$614,000, the value assessed as of initial funding. By adjusting the payout rate and term of the trust, the amount of the transfer subject to gift tax can be greatly reduced.

The CLT also can have significant income tax benefits, but that aspect is not discussed here. Proper planning mandates, however, that a business owner discuss all tax implications of any planning with his or her tax advisors.

As a general rule, CLTs are quite effective in a low interest rate environment because the assumed rate applied by the IRS is closely tied to the prevailing interest rates at the time of funding.

As a general rule, CLTs are quite effective in a low interest rate environment because the assumed rate applied by the IRS is closely tied to the prevailing interest rates at the time of funding. The contribution of a rapidly appreciating asset in a low interest rate environment yields the best tax advantage. If the trust assets grow at a rate in excess of the assumed rate, the donor/business owner “wins” and his or her heirs enjoy transfer-tax advantages. A CLT generally is not appropriate for an asset that will be sold while held by the trust. Instead, a business owner should consider a CLT for assets that he or she wishes to pass to future generations. As with the other techniques discussed herein, the tax treatment of a CLT is complex, and a donor must seek tax counsel before engaging in this type of planning.

Perpetual Gifts

Many business owners are interested in using some or all of their wealth to build a family legacy, which often involves philanthropy. Legacy building involves long-term planning, and two primary tools for this purpose are the private foundation and donor advised fund.

Private Foundation

A private foundation is a charitable entity that can have perpetual existence. It is a grant making organization that is required to make regular distributions, generally 5% of total foundation assets, to other charitable organizations. The foundation can be founded by an individual or family, and in the case of a family, the family members can serve as trustees or directors, working together to determine which organizations to support. The foundation can last as long as it has assets to distribute. In addition to the legacy building aspect of the foundation, it also carries significant tax benefits. Generally, the foundation’s funder is entitled to a charitable income tax deduction for gifts into the foundation.

Private foundations have several drawbacks. First, the amount of the charitable deduction varies with the type of asset contributed. A gift of publicly traded stock should result in a deduction equal to the fair market value of that stock, for instance, while a gift of closely held stock likely will generate a deduction equal only to the stock basis. Another drawback is the limit on the amount of deduction that may be used in one year for a gift to a private foundation, as mentioned earlier. Also, during periods when investment returns are low, the mandatory 5% annual distribution can be burdensome.

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Donor Advised Fund

An alternative to a private foundation is a donor advised fund (DAF). A DAF allows a donor to create a charitable fund within a larger charitable organization, such as a community foundation. Bob could create the Bob's Family Fund within an established foundation. Bob and his family would be the advisors of that fund, making recommendations as to how the monies will be distributed. Generally, there is no minimum distribution requirement from a DAF, and a gift to a DAF is considered a gift to a public charity. Since it is a public charity, a DAF has greater deductibility limits than a private foundation, and also avoids some of the onerous private foundation regulations. However, a DAF is part of a larger organization and is governed by a separate board of trustees or directors. In contrast, a private foundation is a stand-alone entity, subject to only the direction of its governing board, thus giving its creator — or advisors — greater control.

One particularly interesting strategy is the combination of a split interest trust within a private foundation or a donor advised fund. Bob could fund a CRT with Happy Day stock, and he and his wife could enjoy distributions from the CRT for their lives. Upon the death of the surviving spouse, the assets in the CRT then would be directed into Bob's private foundation, or DAF. This arrangement marries the diversification, tax deferral and income benefits of the CRT with the long-term, legacy building aspects of a private foundation or DAF.

The Sum of the Parts Is a Whole Lot of Value

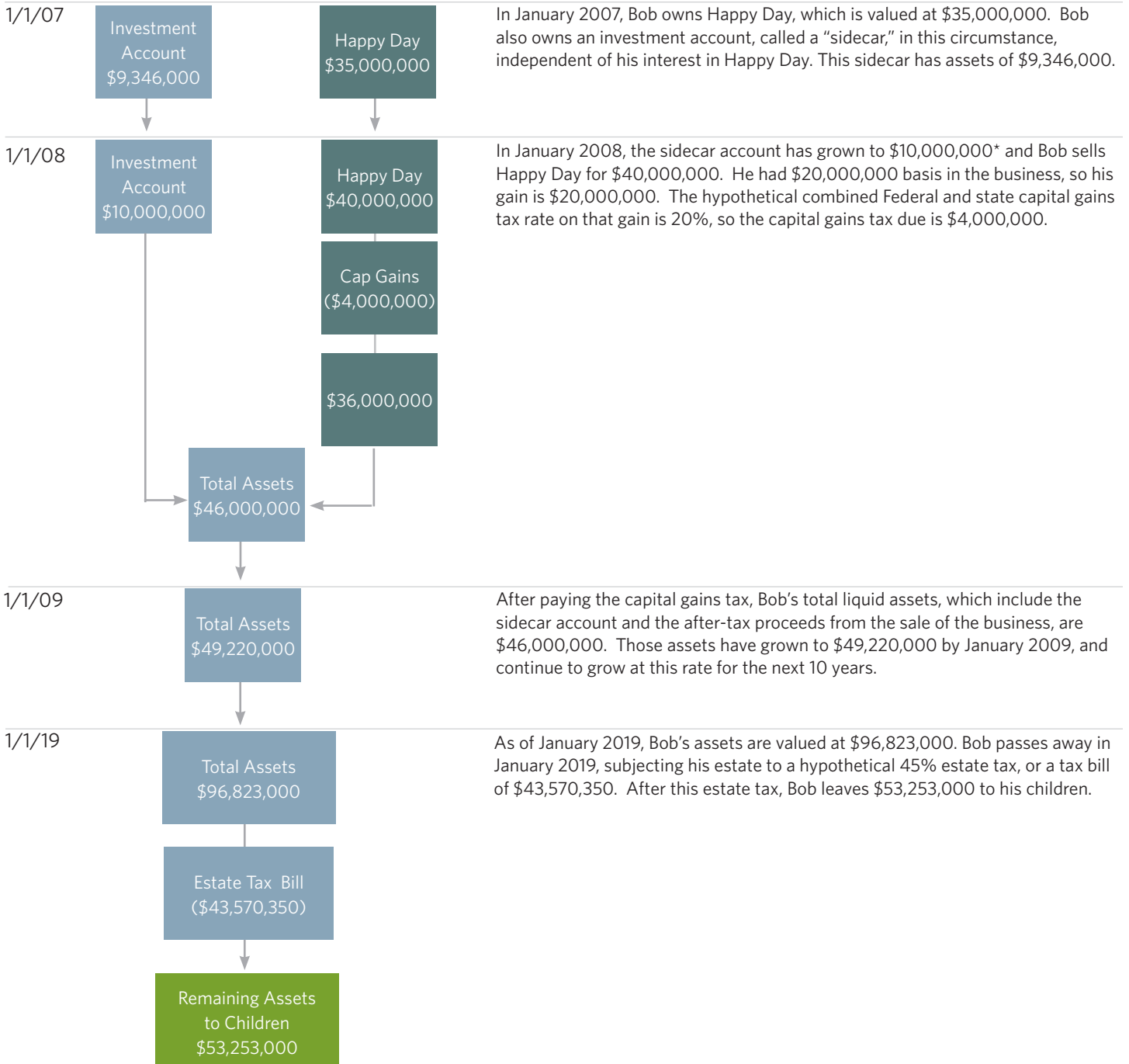
The techniques discussed above were all considered in isolation, but proper pre-transaction planning involves combining multiple techniques to exploit the best aspects of all strategies. For example, a business owner might transfer the family business to a FLP, and then contribute FLP units to the GRAT. In that case, the transfer tax value of the contributed asset — the FLP units — would be reduced when compared to a contribution of shares of the company. The tax benefit of the GRAT would be even more pronounced given the lower initial value of the contribution. This type of very basic planning could result in an additional \$10 million of assets available to Bob's children 10 years after the sale of his business, as opposed to doing no pre-transaction planning. The following case studies tell the story.

From Entrepreneur to Investor

Exhibit 3

No Pre-Transaction Planning

This option demonstrates the outcome of no pre-transaction planning. Bob simply sells the business, pays the capital gains taxes, holds the assets until his death, subjecting those assets to estate taxes before passing the balance to his kids. Let's walk through this option, step by step.



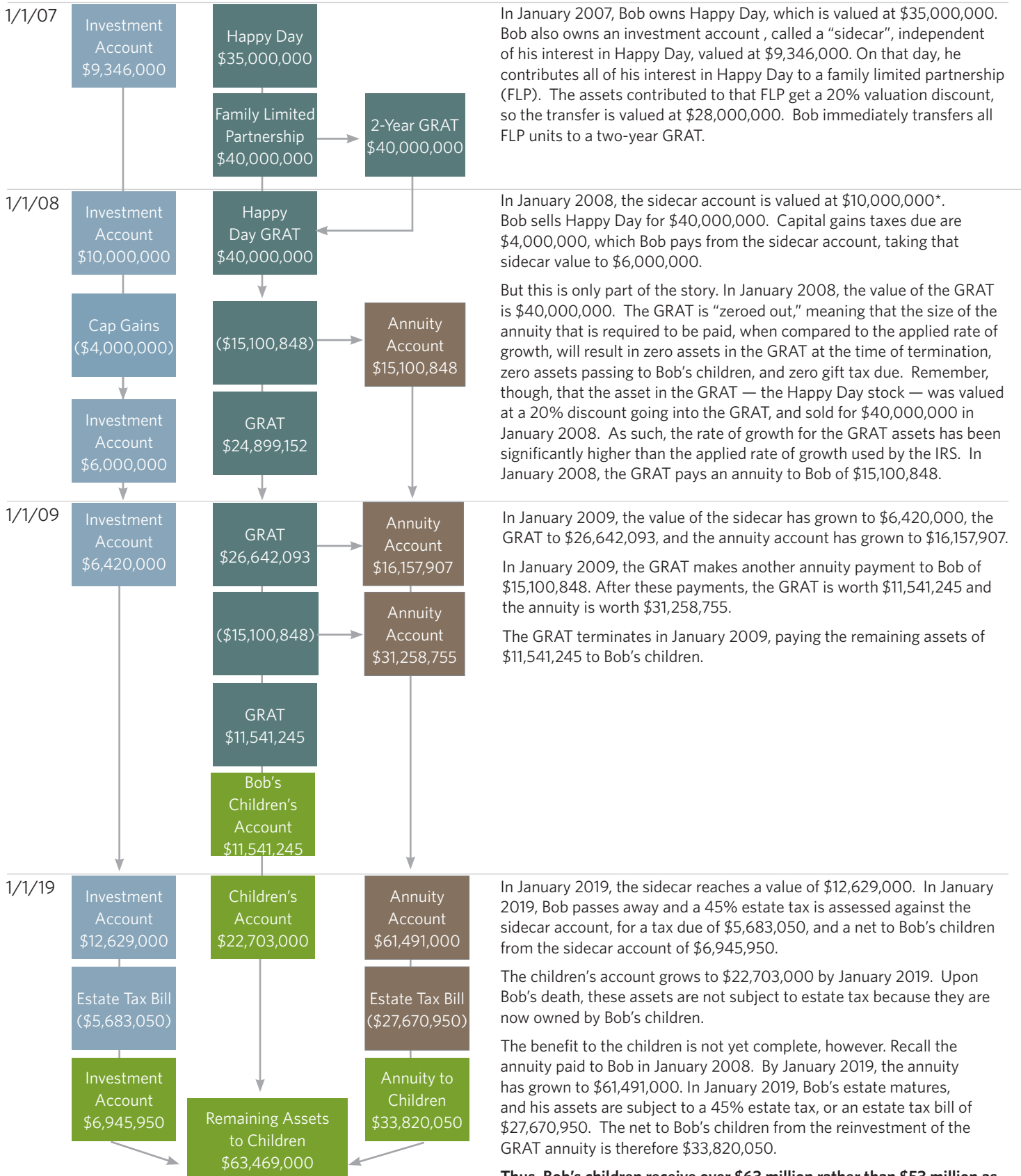
*Assume an annual growth rate of 7% for liquid assets.

From Entrepreneur to Investor

Exhibit 4

Pre-Transaction Planning

This example demonstrates the value of some basic pre-transaction planning. With just a bit of effort, Bob can significantly increase the wealth passed on to his children. Again, a step-by-step treatment of this example is likely most useful.



In January 2007, Bob owns Happy Day, which is valued at \$35,000,000. Bob also owns an investment account, called a "sidecar", independent of his interest in Happy Day, valued at \$9,346,000. On that day, he contributes all of his interest in Happy Day to a family limited partnership (FLP). The assets contributed to that FLP get a 20% valuation discount, so the transfer is valued at \$28,000,000. Bob immediately transfers all FLP units to a two-year GRAT.

In January 2008, the sidecar account is valued at \$10,000,000*. Bob sells Happy Day for \$40,000,000. Capital gains taxes due are \$4,000,000, which Bob pays from the sidecar account, taking that sidecar value to \$6,000,000.

But this is only part of the story. In January 2008, the value of the GRAT is \$40,000,000. The GRAT is "zeroed out," meaning that the size of the annuity that is required to be paid, when compared to the applied rate of growth, will result in zero assets in the GRAT at the time of termination, zero assets passing to Bob's children, and zero gift tax due. Remember, though, that the asset in the GRAT — the Happy Day stock — was valued at a 20% discount going into the GRAT, and sold for \$40,000,000 in January 2008. As such, the rate of growth for the GRAT assets has been significantly higher than the applied rate of growth used by the IRS. In January 2008, the GRAT pays an annuity to Bob of \$15,100,848.

In January 2009, the value of the sidecar has grown to \$6,420,000, the GRAT to \$26,642,093, and the annuity account has grown to \$16,157,907.

In January 2009, the GRAT makes another annuity payment to Bob of \$15,100,848. After these payments, the GRAT is worth \$11,541,245 and the annuity is worth \$31,258,755.

The GRAT terminates in January 2009, paying the remaining assets of \$11,541,245 to Bob's children.

In January 2019, the sidecar reaches a value of \$12,629,000. In January 2019, Bob passes away and a 45% estate tax is assessed against the sidecar account, for a tax due of \$5,683,050, and a net to Bob's children from the sidecar account of \$6,945,950.

The children's account grows to \$22,703,000 by January 2019. Upon Bob's death, these assets are not subject to estate tax because they are now owned by Bob's children.

The benefit to the children is not yet complete, however. Recall the annuity paid to Bob in January 2008. By January 2019, the annuity has grown to \$61,491,000. In January 2019, Bob's estate matures, and his assets are subject to a 45% estate tax, or an estate tax bill of \$27,670,950. The net to Bob's children from the reinvestment of the GRAT annuity is therefore \$33,820,050.

Thus, Bob's children receive over \$63 million rather than \$53 million as a result of some relatively simple planning.

*Assume an annual growth rate of 7% for liquid assets.

From Entrepreneur to Investor

Life After the Business

Prior to the sale, restructuring, or transfer of a business, much attention is paid to the details of the transaction and to the subsequent structure of family finances. In most cases, however, little attention is paid to what the business owner will do after the sale of the business. In reality, myriad issues arise when a type-A business owner transitions from running a business to life after the business. Some of the most common issues that we see involve concerns about control or fulfillment.

Myriad issues arise when a type-A business owner transitions from running a business to life after the business.

Control

Most successful business owners are successful because they have dedicated themselves almost entirely to running their business. The owner knows where every asset is, understands the cash flow, and can measure the profit and loss. She or he turns the lights on every morning and can feel and touch the business' assets. This

familiar circumstance contrasts markedly with a former business owner who is faced with the task of investing the proceeds from the business sale. That person might now be in the position of moving from active control of all investments to being a passive investor, and that often does not sit well with individuals who built and controlled an enterprise. One difficulty is the inability to “see” the assets in an investment portfolio. The investor knows which investments are owned, but doesn't have great vision into those assets. For example, an investor in a mutual fund can't see hour-to-hour, or even day-to-day, what is owned by the mutual fund. Even more dramatic is an investment in a hedge fund; given the unregulated, highly proprietary nature of these vehicles, the fund distributes only minimal information, which can cause great discomfort to a former business owner used to control.

In order to reduce discomfort, it is critical that a business owner opens a dialogue with a wealth manager before receiving the proceeds of a business sale. The wealth manager should be charged with understanding the needs and concerns of the business owner and with creating an appropriate wealth management plan. That plan should be clearly documented in an investment policy statement, and — this is the key — that statement must be followed diligently once the investment plan is funded. The investment policy statement can serve as an anchor for the investor, reminding him or her of the portfolio objectives and strategy in times when the investor might be tempted to stray.

Some former business owners might find that, despite a clearly documented plan, they simply can't resist the “buzz” of chasing a hot investment idea. That thrill seeking is okay and, if appropriate for the personalities involved, can be a part of the investment policy statement. But it should only be a small part. For most business owners, the goal for the proceeds from the sale is wealth preservation; they took extraordinary care and risk in building their wealth and now are interested in ensuring it lasts. Large, speculative investments are not consistent with wealth preservation. Accordingly, many entrepreneurs-turned-investors will dedicate a small percentage of their wealth to a risk capital portfolio. This risk capital is to be deployed entirely at the discretion of the investor, while the wealth manager ensures that the balance of the portfolio is managed in line with the wealth preservation strategy. This approach allows the thrill of risk-taking, while limiting the possible downside.

From Entrepreneur to Investor

Prior to a liquidity event, entrepreneurs should consider how they will fill the days after their business is gone.

Fulfillment: What Do I Do Now?

We all certainly know stories of former entrepreneurs who sold their business with thoughts of retiring to a life of leisure, only to wind up starting another business shortly thereafter. This is endemic of the type of personality often seen in entrepreneurs — they aren't good at being idle.

Understanding this is critically important to the long-term well being of the business owner and his or her family. Prior to a liquidity event, entrepreneurs should consider how they will fill the days after their business is gone.

The answers to this question are as varied as the personalities of business owners, but the answers all come down to allocation of time and resources. They also come down to priorities. Business owners must consider what they value and determine how to apply their considerable talents to those values. Statistics suggest that a person who is healthy at age 50 has a 50/50 chance of living to 100. A business owner who moves out of the business at age 55 will have many productive years ahead. This time could be spent traveling, pursuing philanthropy, babysitting grandchildren, starting a new business, advising nascent businesses, or managing a portfolio of private equity investments.

More and more, the post-business lifestyle seems to be a combination of the above activities. As a result, a cottage industry has emerged to assist with these transitions and advise business owners and executives on next stages. Many of these specialists advocate a comprehensive life view, which mixes different life opportunities, such as paid work, leisure, family, community, and lifelong learning. This philosophy capitalizes on the fact that life after the business can be much more flexible than while running the business. Instead of being constantly tied to running the company, an individual can split time among numerous activities. The key is to find the activities that match the values and preferences of the former business owner. While a relatively new industry, these personal transition specialists can provide valuable assistance, and in some cases have come to be viewed by their clients as just as critical as the advisors engaged to manage the actual business transition or transaction.

In Summary

The decision to step back from running a business is never an easy one and signals the sometimes difficult progression to the next step in a lifetime. Once the decision is made, however, the transition can be seamless if the business owner takes the time to gather the right team of advisors and works with that team to make sure that the deal provides the greatest benefit to the business owner and his or her family. Part of that exercise is to think well in advance about techniques that can be employed to shift wealth as a component of a long-term wealth management strategy. Timing is key in this area — waiting to think about wealth transfer until just before a transaction is closed will result in missed opportunities and diminished assets available to the business owner and his or her family.

In addition to preparing the business, the wealth strategy, and the family, the business owner must also prepare him or herself for life after the business. Traditional retirement seems to be an outdated notion to the current generation of business owners getting ready to transition away from their businesses.

With proper advice and thorough planning, a business owner can put his or her life's efforts to work for the family or to realizing the individual's goals for the next stage of life.