



**7<sup>th</sup> Annual Vermont Employee  
Ownership Conference  
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**The Family Business and  
Employee Ownership**

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**VEOC**

Vermont Employee Ownership Center



# Goals of the Presentation

- Provide an overview of the challenges facing family-owned businesses in transition
- Outline fundamental tax and succession issues facing family-owned businesses
- Review the Vermont Systems, Inc. path to succession through an ESOP
- Discuss the model of family succession with an ESOP.
- Answer your questions!



# Legal Disclosure

- To ensure compliance with requirements imposed by the IRS, we must inform you that any U.S. tax advice contained in this presentation is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding penalties under the Internal Revenue Code or (ii) promoting, marketing or recommending to another party any transaction or matter addressed in this communication.

# Tax Issues Facing Family Business Owners

- Estate tax at federal and state level and the liquidity to pay the tax
- Pass through income and income taxes associated with Subchapter S, partnership and limited liability company profits
- C corporation issues if real estate held in corporation

# Tax Issues Facing Family Business Owners

- Estate tax:
  - Federal exemption at \$3.5mm this year. Next year?
  - Vermont exemption – Legislation passed to reduce the exemption to \$2mm.

# Tax Issues Facing Family Business Owners

- Income taxes:
  - Growing federal deficit
  - Troubles with Medicare and Social Security
  - Will taxes go up? (Or is it only a question of how high?)
- Higher income taxes impacts ability of buyers (including family buyers) to raise funds over time to do the buy out
  - Double, triple and quadruple tax conundrums

# Tax Issues Facing Family Business Owners

- C corporations
  - Double tax on property in the company
  - Used in preferred stock settings
  - Challenging tax environment for small businesses



# Fairness Issues Facing Family Business Owners

- Family in and out of business
  - Wealth tends to be tied up in business
  - Most families desire to treat children evenly
  - Having non working family owners with working family owners can be a problem





# Fairness Issues Facing Family Business Owners

- Addressing the equity issues
  - Other assets
  - Life insurance
  - Using ESOP to create liquidity for some of the stock



# Fairness Issues Facing Family Business Owners

- Using ESOP liquidity
  - Pass on to non-working family members
  - Liquidity for life insurance
  - Warrants from a transaction



# Fairness Issues Facing Family Business Owners

- Charitably inclined owners
  - Do not want to leave part of the business to charity
  - ESOP can be used to create liquidity to fund charitable interests through charitable remainder trust or other vehicles or direct gifts



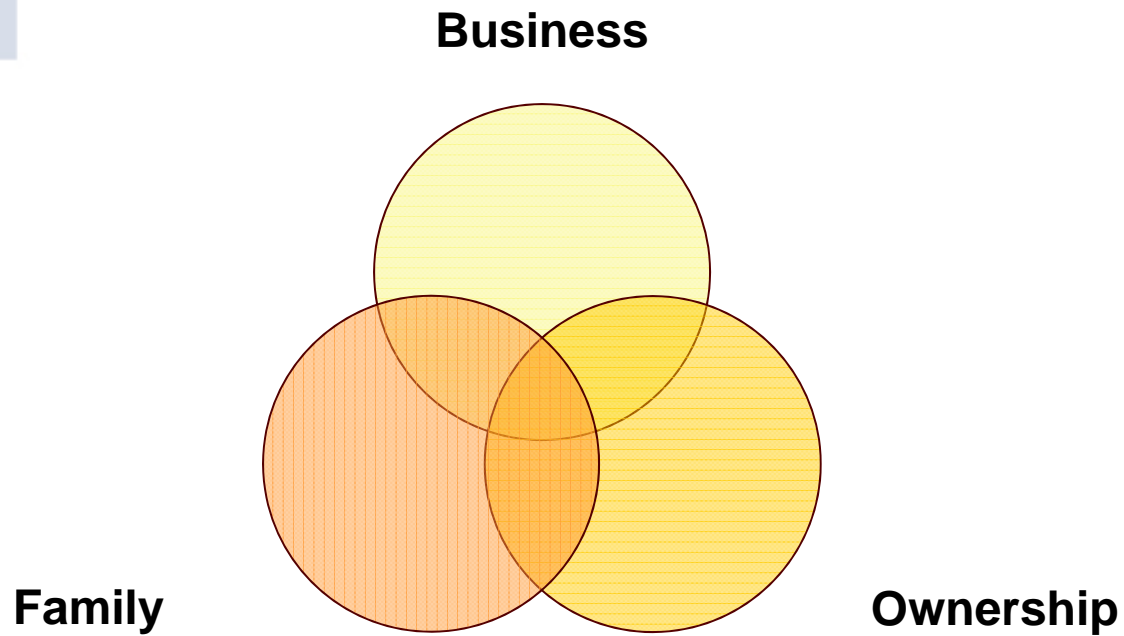
# Family Business Facts

- More than 30% of all family owned businesses survive into the second generation;
- 12% will still be viable into the third generation;
- Only 3% of all family businesses survive into the fourth generation level and beyond.

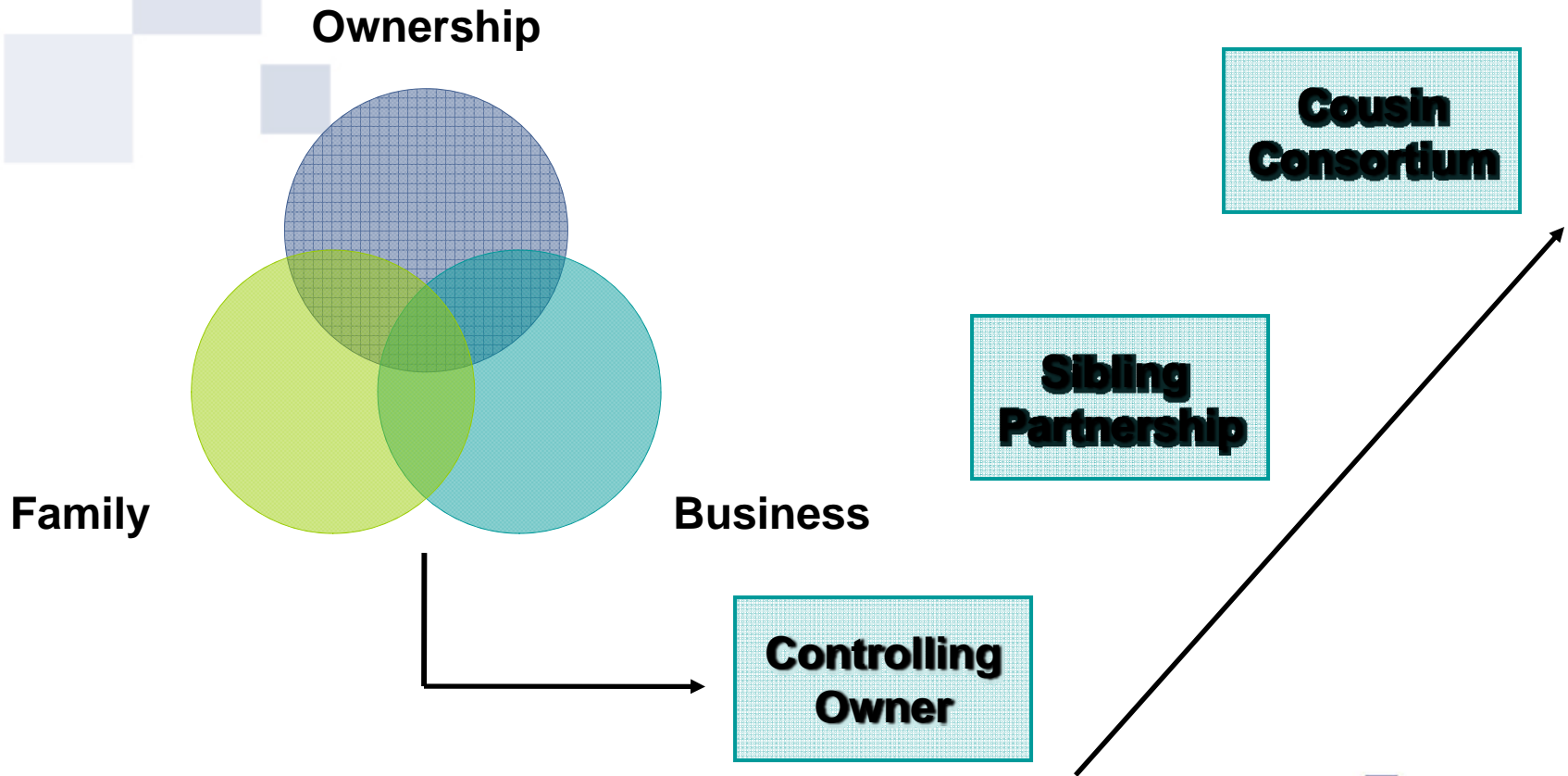
## WHY?



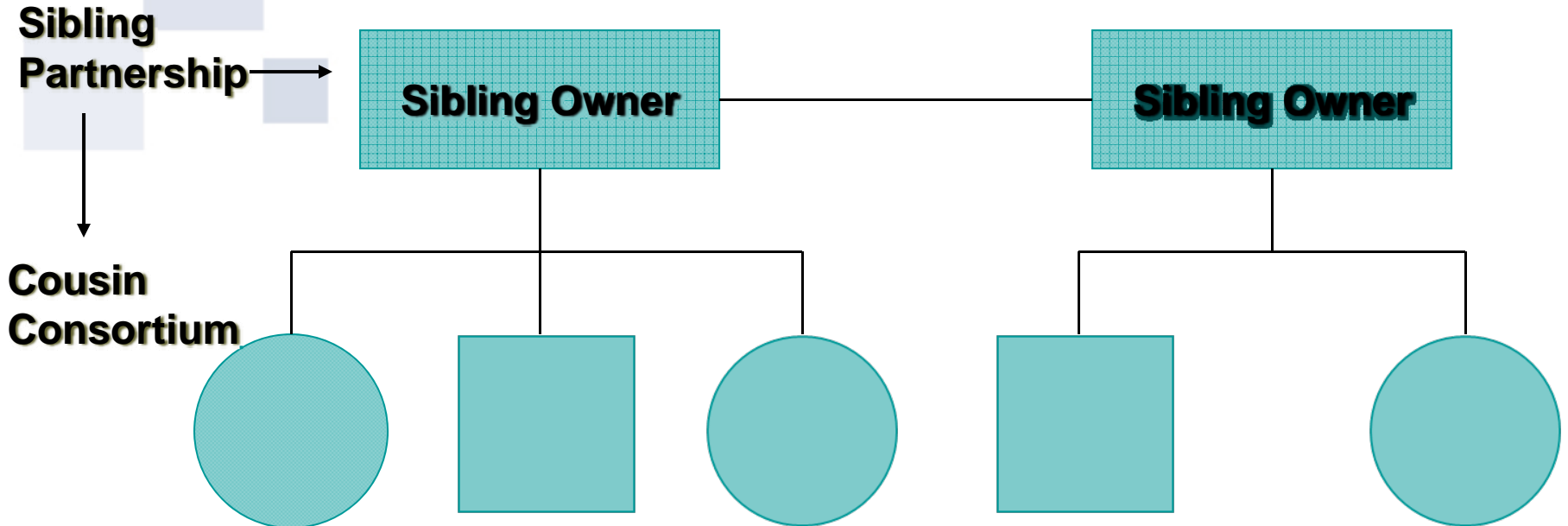
# The Three Circle Model



# The Developmental Stages of the Ownership System



# Stages of Ownership



▪As offspring mature, a “cousin consortium” develops.

▪Cousins come from different family structures and experiences.

# What makes family business unique?

- The presence of family
- The owners dream to keep it in the family – continuity
- The overlap of:
  - Family
  - Ownership
  - Management
- Unique sources of competitive advantage derived from interaction of family, ownership and management, especially when family unity is high.



# Unique challenges facing family business

- Unqualified family members in key positions within the company.
- Communication of business issues is difficult enough, however layered with challenging family matters, often communication completely breaks down.
- Marriage and divorce plays a key role in family business success and failure.
- Involvement of family members not employed by the company.
- Family members in ownership versus management positions.



# Fundamental Issues Facing Family Business Owners

## – “Family-ness”

- Close family unit
- Shared decision making process
- Internal transition
- Preserve the family legacy



# Fundamental Issues Facing Family Business Owners

- Disadvantages
  - Shared ownership
  - Disclosure
  - Close family unity



# Vermont Systems, Inc.

## – Who we are

- From July 1985 to December 1998 we were family owned by 5 shareholders with about 25 employees in 1998
- Since January 1999 we have been 100% ESOP-owned with 90 employees AND the family is still involved!



# Vermont Systems, Inc.

## – Our Counts Before the ESOP

- Employees - - 25
- Gross Revenues - - \$5.5mm
- Net Income - - \$1.4mm
- Income Taxes - - \$700,000
- Share price - - \$551.47 per shares



# Vermont Systems, Inc.

## – Our Counts After the ESOP

- Employees - - 90
- Gross Revenues - - \$16.7mm
- Net Income - - \$4.2mm
- Income taxes - - \$10,000
- Share value - - \$45,055 (adjusted for splits)

# Case Study for Discussion

- Three children in family, one in business while two are not
- Business worth \$5mm
- Owners have little outside net worth except for retirement plan that they expect to use in retirement

# Case Study for Discussion

- Thoughts:
  - Partial ESOP to create liquidity at \$2mm
  - Also use Seller financing with Warrants either to pass equity growth to working side or to grandchildren
  - Stock Appreciation Rights Plan inside company
- Need to be wary of Code Section 409(p)!



# Why Might Owners of a Family Business Consider an ESOP?

- Employees also seen as family.
- Way to create equity interest for non-family management without transferring stock directly.
- Tax, succession planning or diversification reasons.
- It is a way to convert some of the business equity to cash to fund retirement and to create a pot of liquidity that might pass to family that is not in business.
- Root jobs in the community.
- Improve the bottom line by creating ownership mentality.

# Is an ESOP Right for You?

- Consider the complexity, the initial costs, and annual costs.
- Consider objectives of current and successor family shareholders and management.
- Look at tax savings/benefits for C-Corp vs. S-Corp ESOPs.
- Consider whether family can accept an “outside” shareholder.
- But, in some instances, an ESOP can be very helpful for the right family business.



## What Family Businesses Might Use an ESOP?

- Generally profitable companies of more than 20 employees and payroll > \$750K.
- Need good free cash flow.
- An interest in employee involvement is a plus.
- Owners typically looking to cut back and/or diversify.
- Value greater than \$1.0mm



Questions?

