

Tax and Non-Tax Issues to Consider In Business Succession Planning

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What is business succession planning?

Business succession planning is the implementation of a series of strategies created to address critical events in a business (e.g. death, disability, etc.) that would otherwise interrupt the control or operation of a business.

Identifying Objectives

The first step to any succession plan is to identify the goals and timeline of the owner(s). A strong succession plan will likely include layers of strategies tailored to best meet the owner(s) goals and the structure of the business. Some common objectives include:

- Ensuring the business remains in the family
- Funding retirement
- Planning for health concerns
- Ensuring retention of key employees
- Liquidity
- Estate planning

Common Challenges

- Conflicting goals or ambitions of owners (existing and future)
- Complicated and emotionally driven family dynamics
- Hesitance to involve applicable family members in the planning stage (e.g. spouses, adult children, etc.)
- Disproportionate participation in the family business
- Income and estate tax liabilities involved with the transfer of business interests.

Assembling a Team

- Attorneys
 - Corporate attorney
 - Estate Planning attorney
 - Regulatory specialists
- Key employees
- Family members
- Appraiser
- CPAs
 - Outside CPA
 - Internal CFO or Controller
- Financial Advisors
 - Personal Advisor To Owner
 - Investment Banker

High Level Options

- Sale to Third Party
 - Likely maximizes wealth and provides greater liquidity
 - Other options may not be feasible
- Sale to Key Employees or Partners
 - Employee retention through transition periods
 - Can provide source of retirement income
- Gift and/or Sale to Family
 - Family legacy preserved
 - Allows future generations opportunity to participate in and benefit from business

Choice of Entity

C Corporation – Overview

- C Corporation income taxed at 21% rate.
 - Top individual rate is 37%.
 - Even with Section 199A deduction, rate is likely to be more than 30% for individuals with pass-through business income.
 - Dividends to non-corporate shareholders taxed at preferential rate of 20% plus the 3.8% NIIT for certain taxpayers.
- Shareholder cannot use losses incurred by corporation to offset other income
- Who might benefit?
 - Business that operates in multiple states in order to avoid individual owners filing returns in various states.
 - Businesses that are growing rapidly and prefer to self-finance growth.
 - Cash flow can be improved in short-term by decreasing outflow of cash for tax liability

C Corporation – Double Taxation

- Convert to S Corporation
 - Consider limitations on eligible shareholders (generally U.S. individuals and certain trusts)
 - Built-in gain arising prior to S election will be added to entity level tax if assets are sold within 5 years of election.
- Partnership Drop Down.
 - C corporation contributes assets to tax partnership for preferred units.
 - Common units issued to key employees and or owners.

C Corporation – Qualified Small Business Stock

- Non-corporate taxpayer may exclude between 50-100% of capital gains from the sale or exchange of qualified small business stock held for more than five years (limited to the maximum gain exclusion amount)
- Maximum gain exclusion for each shareholder:
 - \$10M or
 - 10 times shareholder's aggregate adjusted basis in the QSBS
- Gross Asset Test
 - At all time prior to, and immediately after, issuance of 1202 stock, its gross assets do not exceed \$50MM; subsequent increases to gross assets do not disqualify previously issued stock, but new 1202 stock cannot qualify either
 - Gross assets means cash + aggregate adjusted bases of other property (but any carryover basis is treated as FMV basis).
- Active conduct of qualified trade or business

C Corporation – Qualified Small Business Stock

- Consider starting business as tax partnership and then convert to C corporation after start up phase to capture increase in value.
- Example: Partnership converts to C Corporation and business is valued at \$20MM.
 - \$20MM is now considered basis for 1202 exclusion so that \$200MM can be excluded.

S Corporation – Overview

- Single level of taxation
- Ownership limitations.
 - Only non-corporate, U.S. shareholders.
 - Only one class of equity - all outstanding shares must confer identical rights to distributions and liquidation proceeds
 - No preferred stock
 - May have voting and non-voting stock
 - Difficult to raise capital
 - Difficult to set up employee incentive equity (compared to partnerships)
- Shareholder-employees can minimize FICA liability through maximizing dividend distributions and reducing salary
 - Dividends should not be subject to FICA
 - Dividends should not be subject to NIIT for shareholder-employees

Tax Partnership – Overview

- Single level of taxation
 - No corporate level tax; all items passed through to shareholders
 - Pass-through income eligible for 199A deduction
 - Shareholders receive K-1 reporting in accordance with partnership agreement
 - Type of economic arrangement can make accounting extremely complex
- Generally permits tax-free contribution and distribution of property
- Ownership considerations
 - Multiple classes of equity are permitted (unlike S corporations)
 - Economic rights can be divorced from voting rights
- Partner can use allocable share of partnership debt to increase own basis in partnership interest for purposes of deducting partnership losses
 - Contrast with S corporation rules, that don't allow debt to increase stock basis
 - Losses are subject to passive loss and basis limitations (same as with S corporations)

Tax Partnership – Departing Partners

- Payments made to a partner for interest in partnership property usually results in capital gain to departing partner
- Other payments to a partner can push ordinary income to the departing partner in the form of a distributive share of partnership income
 - Results in use of pre-tax dollars to fund buyout

Considerations in Structuring or Converting Entities

- Expectation of income from operations
 - If reinvested in business, C corporation lower rate may be attractive.
 - If distributed to owners, pass-through is likely still preferable.
- Expectation of losses from operations
 - Flow through to owners of pass-through entities.
 - Carried forward in C corporation.
- Potential sale of business
 - C corporation allows for possibility of Section 1202 benefit
 - Pass-through provides ability to sell assets and generate majority capital gain
- Retirement Funding/Buyout
 - Partnership taxation allows for more tax-efficient buyout
 - 754 Election allows inside basis step-up in assets

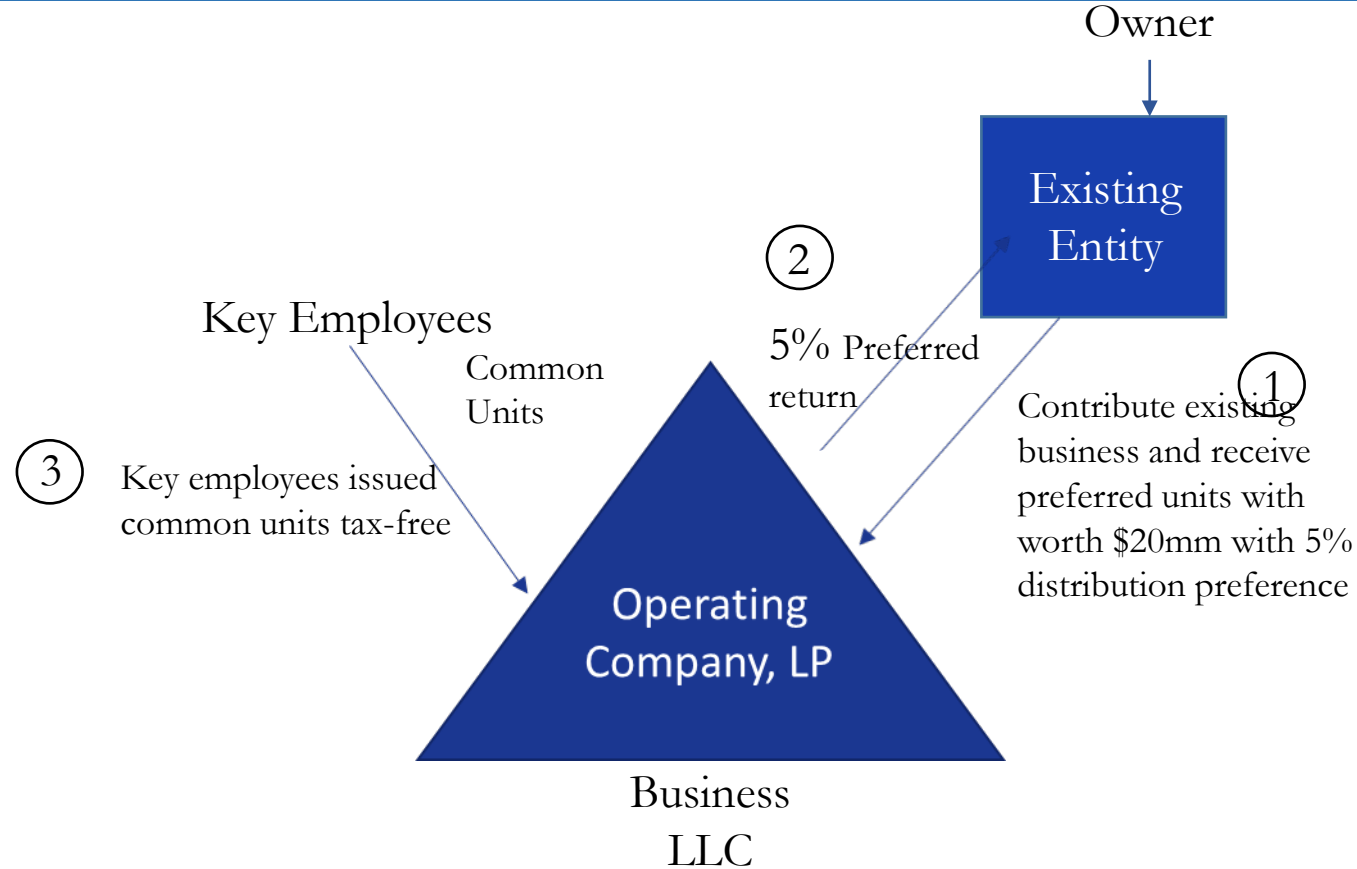
Conversions – Tax Partnership to C or S Corporation

- Many options to implement: state law conversion/merger, distribution of assets to shareholders followed by formation of tax partnership, or partnership drop-down of assets followed by liquidation of tax partnership
- Generally tax efficient
- Concern if debt exceeds tax basis of assets.
 - Recognition of gain under Section 357(c)

Conversions – C or S Corporation to Tax Partnership

- Many options to implement: state law conversion/merger, check-the-box election, corporate liquidation and distribution of assets to shareholders followed by formation of tax partnership, or corporate drop-down of assets followed by distribution of tax partnership interests in liquidation
- Corporate gain
 - Corporation recognizes gain on deemed sale of assets equal to difference between FMV of assets less tax basis of assets
 - C corporation gain taxed at 21%
 - S corporation gain flows through to shareholders, increasing basis in stock, but may have ordinary income because of depreciation recapture
- Shareholder gain
 - Shareholders recognize gain on value on actual or deemed distribution of interests in tax partnership less tax basis in stock of corporation.
- Generally not tax efficient

Preferred Partnership Drop Down



- ① Owner contributes business to new LLC via fee organization or contribution
- ② Upon sale of business owner receives \$20mm and each year is allocated income equal to \$1mm
- ③ Employees receive value of business over the 5% preferred return

Tax Partnership – Preferred Equity Structuring

- A business owner can gradually transfer all of the equity ownership to employees over time, providing business owner with continuing stream of income for duration of buyout period
 - Issue preferred interests to owner/founder, with preference amount at least equal to current value of company, plus desired preferred return rate
 - Grant common interest to employees, to be treated as profits interests
 - Current distributions made only to pay down preferred return
 - Operating income, which is typically ordinary income, will be allocated to preferred interests in amount of preferred return
 - At end of paydown term, the preferred shares are redeemed for the full preference amount, allowing founder to extract prior value of company
 - Employees own the subsequent value created in the company, and have capital gains potential upon sale of the company or sale of assets
 - Employees can own life insurance to redeem estate of owner at death

Wealth Shifting Strategies

- Lifetime exclusion of \$12.9 million
- Pre-transaction gifts enable use of discounts to take into account lack of control and lack of marketability
- Appreciation is removed from taxable estate
- If selling to third party easier to have attention of business owner before process commences
- Prepare financial modeling for business owner

Giftng Considerations

- Spousal Lifetime Access Trust (SLAT)
- Intentionally Defective Grantor Trust (IDGT)
- Beneficiary Deemed Income Trust (BDIT)
- Grantor retained Annuity Trust (GRAT)
- Use of grantor trust status for income tax purposes allows for payment of income tax liability with funds subject to estate tax and is powerful wealth shifting tool.
- Trusts should be designed with trust protector and independent trustee to maximize flexibility

Third Party Sale – Internal Due Diligence

- Review and clean up balance sheet
- Assemble corporate books, governance documents, and records
- Update and compile other records
 - Capitalization
 - Indebtedness
 - Litigation
 - Intellectual Property
- Prepare Inventory and Vendor Lists

Third Party Sale - Restrictive Covenants

- Determine whether employment agreements and/or non-disclosure agreements are needed
- Need consideration to make legally enforceable
 - Equity grant to key employees
 - Discretionary bonus
- Non-compete
- Non-solicitation
- Confidential information

Structuring the Sale – Overview of Asset Sale vs. Equity Sale

- Buyers generally prefer to purchase assets.
 - Purchase price is allocated among assets that will generate depreciation or amortization deductions
 - With changes to accelerated depreciation under the 2017 Tax Act, buyers have stronger incentive for asset deal
 - Liability limited to those items expressly assumed by buyer
 - Seller will pay tax on gain inherent in each asset, which may include ordinary items
- Sellers generally prefer to sell equity
 - Assets retain historical basis
 - Seller desires one level of taxation and capital gain treatment of stock
- Business needs may dictate equity sale
 - Licenses
 - Regulatory concerns
 - Anti-assignment provisions
 - Retitling of assets

Structuring the Sale – Tax Objectives

- Typical objectives
 - Minimize corporate level tax for seller
 - Maximize shareholder capital gains
 - Create depreciable/amortizable basis step-ups for buyer
- A traditional asset sale or equity sale may not achieve all of the objectives
- Alternate structures
 - Sale of personal goodwill
 - Installment obligations
 - Sale of assets with Section 338(h)(10) election
 - Sale of assets with Section 336(e) election
 - Drop into LLC under Rev. Rul. 99-5

Planning for Control of Operations

The control of the operations of a company is vested in the key employees and management of the Company or family members. Control of operations is one of the most difficult areas for most owners to address. Key employees are vital to any business, and very likely to leave during times of transition within a business. To ensure a smooth transition, the following tools may be implemented:

- Employment agreements
- Non-Solicit/non-compete agreements
- Deferred compensation plans / option agreements
- Profit sharing agreements / incentive compensation agreements
- Change of control agreement

Family Succession Ownership Planning

A few common questions used to determine a client's intent regarding ownership succession include:

- What is a fair ownership structure after the death, disability, or divorce of the owner?
- Do any children participate/not participate in the business?
- Are there enough non-business assets to leave any non-participating child interest outside of the business?
- Will the owner continue to own/operate any portion of the business?
- Does the owner require liquidity?

Considerations for Incentive Compensation

■ Contractual Payment

- Less costly to implement than equity compensation
- Easier to document if employee terminates employment
- No income tax recognition by employee until receipt of payment
- Employee may not feel sense of ownership without actual equity

■ Equity Compensation

- More expensive to implement
- Termination of employment can become more complicated
- Income tax issues for employee may be more complex but can allow for capital gain treatment upon sale of entity
- Easier to enforce employment covenants with equity award

Buy-Sell Agreements

Purposes of Buy-Sell Agreements

- Voting Matters
 - Can set forth rights of owners to appoint members of governing board
 - Set forth voting levels for certain major decisions:
 - Admitting new members
 - Borrow money
 - Sell assets
- Prohibit Competition
 - Confidential Information
 - Non-solicitation/Non-interference:
 - Customers
 - Employees
 - Non-compete

Purposes of Buy-Sell Agreements

- Resolve Deadlock
 - Important in 50-50 arrangements
 - Push-Pull:
 - May require mediation prior to invoking push-pull
 - One owner can set price
 - Other owner can decide whether to buy or sell
 - Can set floor and ceiling on price

Transfer Restrictions

Transfer Restrictions

- Limit ability of owner to transfer interest without consent
 - More important for entity with few owners or in which all or most are actively involved
 - Grant right of first refusal to entity or some or all of the other owners

- Carve out for transfers to Permitted Transferees
 - Typical to allow estate planning transfers
 - Can allow transfers to entities controlled by owner
 - Be concerned with indirect transfers

Components: Triggering Events

- Death

- Should entity or other owners be required to purchase
- Should estate of deceased owner have a put right

- Disability

- Important for owners who provide services to entity
- Tie to eligibility for disability insurance payments
- Permissive or mandatory
 - If entity does not exercise, does disabled owner retain voting rights

Components: Triggering Events

- Divorce

- Grant option to divorced owner to acquire interests from divorcing spouse
- If divorced owner does not acquire then grant option to entity or other owners

- Loss of License

- Consider using a reduced purchase price

- Involuntary Transfer

- Important to focus on eliminating voting rights upon involuntary transfer

Components: Triggering Events

- Drag-Along and Tag-Along
 - Allow majority owner to force minority owners to sell to third party (Drag-Along)
 - Allow minority owners right to be included in sale by majority owner (Tag-Along)
- Termination of Employment
 - Important to coordinate buy-sell terms with employment agreement or equity award agreement
 - Consider varying payment terms if terminated for cause
- Retirement
 - Consider requiring owner to sell interests if retire or reach retirement age
 - How about partial retirement?

Components: Purchase Price Methodology

- Agreement of Owners
 - Simple to administer and understand
 - Owners may be resistant to update if friction develops or circumstances change
 - Include mechanism to disregard agreed value if not updated in certain period of time

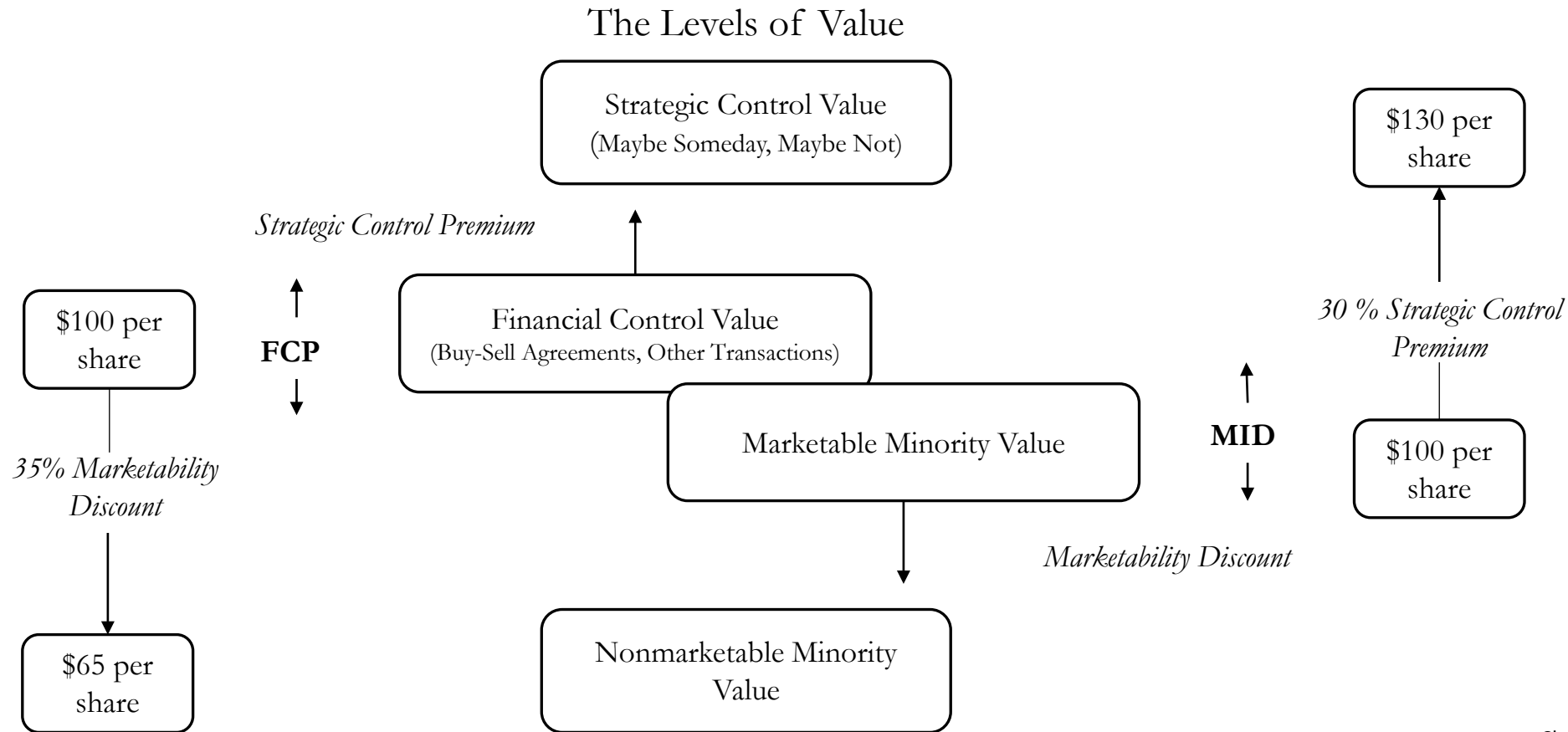
- Formula
 - Simple to administer and understand
 - Formula is usually a multiple of some financial metric such as revenue, EBIDTA, or book value
 - Formula does not take into account reasons for abnormally bad or good year and can produce perceived unfair results

Components: Purchase Price Methodology

- Appraisal
 - Will take into account overall economic factors, industry specific factors, and entity factors

 - Specify which value appraiser should compute:
 - Strategic control value
 - Financial control value
 - Marketable minority value
 - Non-marketable minority value

Components: Purchase Price Methodology



Components: Payment Terms

- Purchase Price
 - The particular triggering event may call for less than 100% purchase price
- Form of Payment
 - Cash
 - Promissory Note
 - Acceleration clause if sale of entity or assets while note is outstanding
- Security
 - Security interest in equity purchased or underlying assets
- Access to Information
 - Financial reporting

Other Considerations

- Other entities
 - Owners may have overlapping ownership in multiple entities
 - Should interests in all entities be subject to buy-sell?
- Debt or Personal Guarantee
 - Consider requiring a release for exiting owner

Estate Tax Considerations

- Important to understand buy-sell requirements for families subject to estate tax
- Potential mismatch if value in buy-sell agreement not respected for estate tax purposes
 - Estate tax computed on fair market value
 - Estate is still bound by price in buy-sell agreement
- Example:
 - Buy-sell agreement sets value at \$12 million
 - IRS successfully challenges pricing methodology and determines value is \$20 million
 - Estate is required to sell interest for \$12 million but pay estate tax on \$20 million (additional \$3.2 million tax)
 - Shortfall may be borne by descendants who do not have ownership interest in business

Funding the Buyout

- Life Insurance

- Avoid Code Section 2042 “incidents of ownership.”
 - Right to change beneficiary
 - Right to access cash
 - Right to cancel policy
- What if the policy exceeds the purchase price?

- Cross-purchase Arrangement

- Each owner owns policy on other owner(s)
- Administratively difficult if many owners
- Deceased owner’s estate should receive an income tax basis increase equal to fair market value at date of death
- Address what happens to policy on life of surviving owners held be estate of deceased owner(s)

Funding the Buyout

■ Redemption

- Entity is owner and beneficiary of policy on lives of owners
 - Code Section 2042 concerns if one owner owns a majority of interests
- Easier to administer with many owners
- Deceased owner's estate should receive a tax basis increase equal to fair market value at date of death
 - Entity should receive proceeds income tax free
 - Other owner(s) do not receive tax basis increase in redeemed interest