# THE FULL MONTY ON CLOSELY HELD BUSINESS PLANNING: CREATING A PLAN THAT COVERS ALL ANGLES


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# THE FULL MONTY ON CLOSELY HELD BUSINESS PLANNING: CREATING A PLAN THAT COVERS ALL ANGLES[1]

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**Brett T. Berly**

I. **OVERVIEW**.

A. **General Discussion Points**.

1. Succession Planning of Company (next generation of owners).

2. Potential Sale of Company (exit strategy; stock sale vs. asset sale).

3. Estate Planning Documents of the Owners and Their Spouses.

4. Recapitalizations and Share Exchanges.

5. Shareholders' Agreement and Buy-Sell Agreements.

6. S-Corporation Elections.

7. Choice of Entity Considerations.

B. **Typical Scenario**.

1. This presentation shall focus on a typical company setting in which the company and its owners explore two different routes:

a. Keep the company and focus on the next generation of owners; or

b. Look for an exit strategy and sell the company.

2. Scenario Facts. Newco was started years ago by two owners, Jim and Dave, both of whom have always worked in the business. Jim and Dave each own 50% of Newco. Newco has steadily grown over the years and is valued at approximately $30 million. Jim has one child, a son who is involved in the business. Dave has two children, only one of whom is involved in Newco. Both Jim and Dave are getting older and are starting to wonder what to do with the company, whether they should be preparing for the next generation of owners or looking for an exit strategy to sell Newco.

[1] Unless indicated otherwise, all references to Code, I.R.C., Section or § are to the Internal Revenue Code of 1986, as amended through the present.

## II. ROUTE NO. 1: OPTION OF SELLING NEWCO IS ALWAYS ON THE TABLE, BUT JIM AND DAVE WANT TO KEEP NEWCO AND ARE MORE FOCUSED ON THE NEXT GENERATION OF OWNERS.

A. **Wills and Estate Planning Documents.** The shareholders must analyze the present status of their wills and other estate planning documents for themselves and their families. They must decide whether new or updated documents are needed. Factors that should be considered include:

1. Are the current documents structured to minimize estate taxes? Although there exists a significant amount of uncertainty with respect to the federal estate and gift tax, most planners expect that these taxes will remain in-force for the foreseeable future. As such, Jim's and Dave's wills should be structured to defer and/or eliminate these taxes through the use of bypass trusts.

2. Which of the beneficiaries are involved in the business? The answer to this question can significantly affect how their estate plans need to be structured.

   a. Example: Jim's wife and son are both involved in the business, but Dave's wife is not involved and only one of Dave's children, his daughter, has taken an active role in Newco.

      (i) Jim's planning: The commonly seen plan of naming Jim's wife as Trustee of the trust created in his will should pose few problems as she is involved in Newco's day to day operations.

      (ii) Dave's planning: On the other hand, Dave (and Jim, as well) may have concerns about giving the right to control ½ of Newco's shares to someone who has no experience with the company. As such, Dave may need to appoint his daughter as Trustee of the trust for Dave's wife. Additionally, Dave may want to consider whether his daughter should inherit a larger portion of his interest in Newco upon the death of him and his wife. This, of course, could lead to conflict within Dave's family if the children are not treated equally. Life insurance and the creation of voting and nonvoting units can be utilized to equalize the economic benefits among the beneficiaries while at the same time providing for the continued success of Newco.

3. Is there sufficient liquidity to pay estate taxes without selling Newco? Due to Newco's value, it is likely that estate taxes will be imposed upon the deaths of Jim and Dave and their respective spouses. This problem is often solved through the use of life insurance trusts and/or buy-sell

agreements designed to provide liquidity to the deceased shareholder's estate.

B. **Current Organizational Structure and Tax Status of the Company**.

1. General State Law Considerations. Is the company organized properly for state law purposes?

   a. The company may have outgrown its single company structure.

   b. If the company has grown into many lines of businesses, it may be time to consider asset protection and reorganize into a holding company structure with multiple subsidiaries.

   c. Should the company still be a Texas entity? Many companies switch to Delaware or organize new entities in Delaware.

   d. If the company's business premises are owned in the operational entity, it may be a good time to spin the property out of the company to a separate limited partnership or limited liability company, and then lease back the real property to the business entity.

   e. Generally, corporations, limited partnerships ("LPs"), and limited liability companies ("LLCs") provide similar and adequate protection for owners against the liabilities of the company, but there are differences.

2. Charging Order Benefits of an LLC – Potential Conversion. If the owners of Newco decide to keep the company, and if Newco is organized as a corporation, some consideration should be made to converting Newco from a state law corporation to a state law limited liability company pursuant to the conversion statutes of the applicable state. If properly structured, the conversion from a corporation to an LLC should not trigger any federal income tax consequences, as it will qualify for tax-free reorganization treatment as a "F" reorganization under Section 368(a)(1)(F) of the Code. Pursuant to the conversion statutes, Newco would be considered the same company, just in a different corporate form. All of Newco's assets and liabilities will automatically carry over and vest into the new LLC.

   a. Charging Orders for Corporations. When a shareholder of a corporation is personally sued (for something unrelated to the business he owns) and is found liable, the court in such case typically issues a judgment against such shareholder in favor of the plaintiff or creditor for a monetary amount. To the extent that such shareholder does not have the funds to satisfy the judgment, the creditor can seek to take control or ownership of other non-cash assets of the shareholder such as his stock in a corporation (which can be a valuable asset to the creditor). The creditor can petition the court to issue what is commonly known as a "charging order." If the court issues a charging order in favor of the creditor, the creditor may take over the shareholder's shares in the corporation (referred to as "charging" his shares). In this case, the creditor obtains all rights related to the shares, including voting rights. In a case where the shareholder has sufficient shares to control the company, the creditor would then be in control of the company. When a creditor takes over a minority shareholder, there can still be difficulties especially if certain actions require supermajority approval.

b. <u>Charging Orders for LLCs</u>. In contrast, if a member of an LLC is personally sued and found liable, the creditor cannot typically receive a charging order against the member's ownership interest in the LLC. If the court rules in favor of giving the creditor the member's ownership interest in an LLC, the creditor in most cases becomes an "unadmitted assignee" and is not considered a normal member of the LLC. Thus, the creditor does not receive the voting and management rights of a normal member and has no rights to review the company's records and tax returns. Instead, the creditor, as an unadmitted assignee, only receives the right to distributions of profits (essentially an economic interest). Accordingly, the members maintain the rights to manage the business and control the decisions of the LLC. Furthermore, if the members control the LLC, they may choose not to distribute profits. Given these restrictions, creditors generally are deterred from attempting to go after ownership interests in LLCs.

c. <u>Charging Orders for Limited Partnerships</u>. The limited partnership structure offers generally the same charging order protection features of the LLC discussed above.

3. <u>Considerations in Choice of Entity</u>.

a. <u>LLCs</u>.

(i) Most popular form of entity.

(ii) Provide protection against charging orders.

(iii) Member-Managed LLC vs. Manager-Managed LLC.

(iv) Have issue with self-employment tax exposure. We are seeing an increasing number of LLCs either convert from partnerships to S-corporations for federal income tax purposes or elect to be taxed as S-corporations at formation.

(1) Put another entity as the sole Manager of the LLC to alleviate self-employment tax exposure. LLCs can have other legal entities serve on its Board of Managers. For corporations, generally only individuals can serve on its Board of Directors.

b. <u>LPs</u>.

(i) Still see many LPs because most were formed when LPs were exempt from old Texas franchise tax. Not as popular without franchise tax exemption.

(ii) LPs are administratively burdensome because of two-tiered entity structure (another entity typically serves as general partner).

(1) Prone to documentation errors. Contracts and agreements constantly executed incorrectly.

(2) Limited partners cannot materially participate in management of LP, or faces risk of being characterized as a general partner (liability risk).

(iii) Still see quite a few LPs with individuals as general partners, which create liability exposure.

(iv) Many LPs that are taxed as partnerships are converting to LLCs.

(v) LPs that are taxed as C-corporations or S-corporations are converting back to traditional state law corporations (or LLCs taxed as a corporation for charging order protection).

c. <u>S-Corporations</u>.

(i) S-corporations provide more tax planning opportunities for self-employment tax, but:

(1) Lack flexibility in distributions.

(2) Under constant attack from proposed legislation.

(3) Hurdle for private equity investors (discussed further below).

4. S-Corporation Planning.

a. Looking Ahead. Although Jim and Dave are focused on the next generation of owners and want to keep the company, if the company is taxed as a C-corporation, a buy-out offer can still arrive at any time. As further discussed below, most company sales are structured as asset sales. Thus, the shareholders should consider making an S-election to get the clock ticking on built-in gains exposure under Section 1374.

b. The Tax Implications of being a C-Corporation.

(i) Capital Gains and Dividend Rates. Congress gave taxpayers a break when it passed the 2010 Tax Relief Act, extending the 15% maximum tax rates on qualifying dividends and long-term capital gains for two more years.[2] Like many congressional actions, however, this was a temporary measure and was scheduled to expire on December 31, 2012. As part of the American Taxpayer Relief Act of 2013, lawmakers agreed that the favorable tax rate of 15% should remain in place for taxpayers earning less than the maximum $400,000/$450,000 threshold. Taxpayers in the highest bracket will pay tax on capital gains and dividends at a rate of 20%.

(ii) Accumulated Earnings Tax. The accumulated earnings tax is a penalty tax. It is imposed on C-corporations perceived as trying to avoid or defer shareholder income tax through an unnecessary accumulation of earnings. The accumulated earnings tax threat is intended to encourage corporations to make timely payments of dividends, thus triggering the double taxation of C-corporation earnings.[3] When applicable, the accumulated earnings tax is levied on "accumulated taxable income" at a rate of 15%. The accumulated earnings tax penalty is over and above the general corporate tax rate of 35%.

c. Double Taxation of a C-Corporation vs. Pass-Through Taxation of an S-Corporation.

(i) A C-corporation is subject to the potential "double taxation" of corporate earnings. The C-corporation's income is taxed first at the corporate level, and any after-tax earnings distributed to shareholders as dividends are generally taxed again as dividend income to the

[2] Job Creation Act of 2010 (2010 Tax Relief Act) (Pub. L. No. 111-312).
[3] I.R.C. § 531.

shareholders. The highest current corporate tax rate is 35%. The current tax rate for qualified dividends is 15% - 20%.

(ii) An S-corporation is a pass-through entity for federal income tax purposes and is typically not subject to an entity-level tax. The shareholders must pay tax on their proportional share of income as reflected on their respective Schedule K-1. The ultimate tax paid is based on the shareholder's tax rate (maximum individual rate of 39.6% currently, but subject to go up at the beginning of 2013) and an individual shareholder may take advantage of the preferable capital gain rates on capital gains of the entity.

(iii) If an S-corporation has taxable income, but its Board of Directors decides to keep all funds in the company without making any distributions, the shareholders will have to pay their respective income tax on their proportional share of the company's income out of pocket. A company that decides to keep funds in the company for working capital needs or expansion typically makes minimum tax distributions to its shareholders in amounts sufficient for each shareholder to pay his or her taxes from the company's income.

(iv) Minority shareholders should keep an eye out as to whether the company will make minimum tax distributions. They may want to insist on minimum tax distributions in a shareholders' agreement.

5. <u>Restrictions on S-Corporation Shareholders</u>. S-corporations <u>cannot</u> have:

a. More than 100 shareholders;

b. A shareholder (other than an estate and certain trusts and exempt organizations) who is not an individual (*i.e.*, another corporation cannot be a shareholder of an S-corporation);

c. A non-resident alien as shareholder; or

d. More than one class of stock.[4]

(i) The restriction on types of shareholders may be a hurdle in receiving private equity funds because private equity firms are typically organized as legal entities (thus, no private equity firms or venture capitalists as direct shareholders). The expansion needs of a company must be considered before making an S-election.

(ii) The S-corporation can contribute its assets and business to a new LLC or partnership and have the private equity firm invest in (and become an owner of) the new LLC or partnership.

6. Estate Planning for an S-Corporation. An S-corporation cannot be owned by a family limited partnership, so qualifying trusts are used.

a. Grantor Trusts. Grantor trusts are domestic trusts that are treated as being owned by an individual ("grantor") who is a U.S. citizen or resident during the period the trust holds the S-corporation stock.[5] The grantor, not the trust, is treated as the shareholder. After the grantor dies, the trust may continue as the shareholder for two years.[6]

b. Estates. A decedent's estate may be an S-corporation shareholder.

(i) An estate is not required to file an election to continue the S-corporation status when the stock of an S-corporation owned by the decedent at the time of his death is held in the decedent's estate.[7]

(ii) This treatment is not unlimited, however, as the estate is considered terminated after the expiration of a reasonable period for the performance by the executor of all the duties of administration (regardless of whether all of its assets have been distributed) per Treas. Reg. Section 1.641(b)-3.

[4] A corporation does not violate the single class of stock requirement if it has shares of common stock with different voting rights as long as, except for the difference in voting rights, the shares shall have identical rights for all purposes. Accordingly, provided that all remaining rights are identical, the issuance of Class A Voting common stock and Class B Nonvoting common stock is permitted without violating the single class of stock requirement.
[5] I.R.C. §§ 1361(c)(2)(A)(i) and 1361(c)(2)(B)(i); Treas. Reg. § 1.1361-1(h)(1)(i), 1.1361-1(h)(3)(i)(A).
[6] I.R.C. § 1361(c)(2)(A)(ii).
[7] I.R.C. § 1361(b)(1)(B).

c. Qualified Subchapter S Trust ("QSST").[8] Qualified Subchapter S trusts allow a grantor to transfer shares he or she owns in an S-corporation into a trust.

(i) Requirements:

(1) There can be only one current income beneficiary;

(2) All of the income of the trust must be distributed to the trust's current income beneficiary at least annually;

(3) Principal of the trust may only be distributed to the current income beneficiary;

(4) The current income beneficiary must be a U.S. citizen or resident;

(5) If the trust terminates during the current income beneficiary's lifetime, then all assets of the trust must be distributed to the current income beneficiary; and

(6) An election to treat the trust as an eligible S-corporation shareholder must be made.

(ii) Election: The QSST elections generally must be filed with the IRS by the current income beneficiary within 2 1/2 months of the transfer of the S-corporation stock to the trust. Failure to file jeopardizes the company's S election. A QSST must file a separate election for each S-corporation in which it owns stock. The election is filed at the service center in which the S-corporation files its income tax returns.

(iii) Taxation: Once the QSST election has been filed, the current income beneficiary will be treated as the "owner" or "grantor" of the portion of the trust constituting the S-corporation stock (but not as to any other assets of the QSST) under Section 678 of the Code.

d. Electing Small Business Trusts ("ESBT"). Section 1361(e) of the Code allows a trust which does not meet the requirements of a QSST to qualify as an S-corporation shareholder by electing to be an ESBT. Unlike QSSTs, ESBTs are allowed to have multiple

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[8] I.R.C. § 1361(d).

income beneficiaries, and the trust does not have to distribute all income.

(i) Requirements:

(1) All of the "beneficiaries" of the trust must be individuals, estates, or charitable organizations as described in Section 170(c)(2) – (5) of the Code. A "beneficiary" of an ESBT is any person who has a present, remainder or reversionary interest in the trust, but does not include those persons whose interest in the trust is so remote as to be negligible or those in whose favor a power of appointment may be exercised.

(2) No interest in the trust is permitted to have been acquired by purchase. However, this does not mean that the ESBT cannot purchase assets from other parties.

(3) An election to treat the trust as an ESBT is timely made.

(ii) Each "potential current beneficiary" of the ESBT must be counted as a shareholder for purpose of the 100 shareholder limitation. A "potential current beneficiary" means, with respect to any period, any person who at any time during such period is entitled to, or at the discretion of any person may receive, a distribution from the trust (income or principal) other than persons who simply hold a future interest in the trust or those in whose favor a power of appointment may be exercised.

(iii) Election: Similar to the QSST, the election to treat the trust as a ESBT must be filed within 2 1/2 months of the transfer of the S-corporation stock to the trust. Unlike the QSST, however, the ESBT election is made by the Trustee of the trust. The election is filed at the service center in which the S-corporation files its income tax returns.

(iv) Taxation: The income of an ESBT from an S-corporation (other than capital gains) is taxed to the trust at the highest rate applicable to trusts and estates. All other income may be taxed to the beneficiaries of the trust if distributed to them as DNI.

C. **Recapitalization and Share Exchanges**.

1. Recapitalizations. A recapitalization is a change in the capital structure of a single corporation and is mostly achieved through an exchange of stock for stock.

   a. A recapitalization is a tax-free reorganization under Section 368(a)(1)(E) of the Code.

   b. "Recapitalization" is not defined by the Code or the Treasury Regulations, but is basically a "reshuffling of the capital structure within the framework of an existing corporation."[9]

   c. In the succession planning context, a recapitalization is typically done to change capital stock structure of a corporation from one class of common stock to Class A Voting common stock and Class B Nonvoting common stock.

   d. The charter of the corporation is amended to provide for newly authorized classes of stock. Old existing shares of common stock are exchanged for the newly authorized shares of Class A Voting stock and Class B Nonvoting stock in a pre-determined ratio. This ratio should be determined carefully to ensure there are enough Class B Nonvoting shares to achieve objectives of succession planning.

   e. In dealing with an S-corporation, the company and its shareholders must be careful that the newly authorized and issued Class A Voting stock and Class B Nonvoting stock have identical rights except for voting differences (pro rata rights to distributions and liquidation proceeds).

   f. In dealing with C-corporations that want to undergo a recapitalization and make an S-election, the authorized and issued shares must be carefully reviewed and analyzed. Preferred Stock must be eliminated and can be problematic in achieving tax-free treatment.

   g. The creation of Class B Nonvoting shares permits controlling Shareholders to gift and/or sell shares to family members without giving up control (Class B Nonvoting shares are typically valued less, which permits more "bang per buck").

   h. Class B Nonvoting shares can be sold or given as bonuses to key employees (again, without giving up control). Typically,

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[9] *Helvering v. Southwest Consol. Corp.*, 315 U.S. 194 (1942).

employees want equity and prefer real shares in a company with equity (albeit nonvoting) over phantom stock.

i. With closely held corporations, there may be few shares authorized, and all of the authorized shares may be issued (for example: only 100 authorized shares, and all 100 are issued). In this scenario, the corporation may be looking for additional investors and will need to authorize more shares. A recapitalization can be used to authorize more shares and effectuate a forward stock split in which the current issued shares are exchanged for more shares (the ownership percentages of the shareholders remains the same, but more shares are issued and authorized).

2. Share Exchanges. Similar to a recapitalization, Section 1036 of the Code also grants non-recognition treatment to exchanges of stock for stock.

a. Motives of a share exchange are similar to a recapitalization.

b. One major difference between a share exchange and recapitalization is that in a share exchange, there is generally no need to amend the charter.

c. Share exchanges are used in situations where a corporation has authorized shares of Class A Voting stock and Class B Nonvoting stock, but only Class A Voting shares are issued. The holders of the Class A Voting shares desire to exchange some of their Class A Voting shares for Class B Nonvoting shares for gifting and/or sale purposes. Again, this ratio should be determined carefully to ensure there are enough outstanding Class B Nonvoting shares to achieve objectives of succession planning.

D. **Gift and/or Sale of Shares to Family Members or Key Employees**.

1. Transfers to Family Members. Going back to our hypothetical scenario, if Jim and Dave expect that the value of Newco will continue to rise, they should consider options to transfer such appreciation to their family members in order to avoid unnecessary estate taxes.

a. Gifts of Shares: Given the historically high level of the estate and gift tax exemption equivalent currently in effect ($5,000,000 per person) and the uncertainty associated with how long it will be available, Jim, Dave and their respective spouses should consider transferring some portion of their interest in Newco in order minimize or eliminate future estate taxes.

(i) If the interest in Newco is Jim's separate property (thus his wife's interest in the community property may be relatively small), he may choose to transfer a portion of his shares to his wife to ensure her exemption is fully utilized (in the event portability is gone after 2012).

(ii) Jim and Dave may want to consider transferring their interest in Newco to trusts of which their wives are the current primary beneficiaries and their descendants are the secondary beneficiaries. This trust can be structured such that the property in the trusts will not be includable in the spouse's estate for federal tax purposes, although she will be able to enjoy the income from Newco during her lifetime.

(iii) Similar to the preceding paragraph, Jim, Dave and their respective spouses should consider transferring a significant number of the shares to trusts for their children in order to "freeze" the value for estate tax purposes to its current value.

b. <u>Sale of Shares to Trusts</u>: As each of Jim's and Dave's interest in Newco exceeds each of their (and their wives') respective exemption equivalents, they may want to consider selling a portion of their Newco shares to trusts created for their children.

(i) Often these sales are made to an Intentionally Defective Grantor Trust ("IDGT"). Drafted properly, the intentionally defective trust is created as a grantor trust with a purposeful flaw that causes the grantor to be treated as the "owner" of the trust for income tax purposes but not estate tax purposes.[10] The grantor is required to pay all of the income tax attributable to the trust, thereby decreasing the size of his or her estate and making an indirect, tax-free gift to the trust every year. Note, however, that there is no step-up in basis on the assets upon the transfer to the trust, as it is part of a gift transaction.

(ii) <u>Example</u>: Jim decides to sell 1/3 of his interest in Newco to an IDGT created for the benefit of his son. Either his wife or his son, per the succession agreement, will be the Trustee of this trust.

(1) Jim sells the shares in return for a promissory note (secured by the interest in the shares). The note should bear interest in an amount no less than the AFR in the month in which the sale is completed.

[10] The grantor trust rules can be found at I.R.C. §§ 671-679.

(2) In order to avoid concerns that the sale is not a bona fide transaction, the ratio of the trust's assets prior to sale and the value of the interest purchased should be at least 1:9.

(3) Payments on the promissory note should be made in accordance with its terms (which may be interest only with a balloon payment upon maturity of the promissory note).

(4) Because Jim is treated as the owner of the IDGT for income tax purposes, no gain or loss is recognized as a result of the sale nor is the interest treated as current income because Jim is treated as having sold the shares to himself. Nevertheless, if drafted properly, only the promissory note and its proceeds (a depreciating asset) will be included in Jim's estate as opposed to the appreciated value of the transferred shares.

(5) *Caution:* Many planners have concerns that Jim's death during the term of the promissory note will result in recognition of capital gains.

c. Future Opportunities: Once the above described transfers have occurred and the trusts created to hold the shares have been funded, Jim and Dave should consider whether these trusts should participate in any future business opportunities.

2. Voting Control. If Newco has voting and nonvoting shares, then Jim and Dave will be able to retain control of Newco while at the same time transferring a significant portion of its value using one of the techniques discussed above.

a. Example: In Dave's case, the interest in Newco is the community property of him and his wife. The agreement that Jim and Dave have made regarding the succession of control of the company following the death of Dave requires that Dave's daughter (and not his wife) has the right to vote these shares.

b. Dave's will can direct that his interest in the voting shares be distributed to a trust for the primary benefit of his wife, of which his daughter will be Trustee, thus satisfying the agreement as to his interest; however, Dave does not have the right to transfer his wife's community property interest in those same shares.

c. As such, to avoid triggering the buy/sell provisions of the succession plan, Dave and his wife should consider transferring the voting shares to an inter vivos trust which provides that Dave's daughter will be Trustee upon his death or incapacity. Dave's wife can be the beneficiary of this trust during her lifetime.

3. Sale and/or Gift of Shares to Key Employees. Class B Nonvoting shares can be sold or issued as bonuses to key employees without giving up control. Bonuses paid to employees are allowable deductions when paid in good faith as additional compensation for services actually rendered by the employees, provided that the *total* of bonus plus salary does not exceed a reasonable compensation for the services rendered. It is immaterial whether bonuses are paid in cash, in kind, or partly in cash and partly in kind.[11] Donations made to employees and others, which do not have in them an element of compensation, or are in excess of reasonable compensation, are not deductible.

E. **Shareholders' Agreements (Corporations) and Buy-Sell Agreements (LLCs and LPs)**. An entity and its owners (regardless of entity type – corporation, LLC, LP) should strongly consider entering into a Shareholders' Agreement or a Buy-Sell Agreement, as the case may be, to address certain rights regarding the transfer of ownership interest upon the occurrence of certain events.

1. The lack of a Shareholders' Agreement or Buy-Sell Agreement can wreck a company upon the death or divorce of a substantial owner or upon deadlock among owners.

2. Examples of provisions in a Shareholders' Agreement or Buy-Sell Agreement include:

a. Restrictions on transfers;

b. Rights of first refusal;

c. Rights upon death or disability of an owner;

d. Rights upon divorce of an owner (Texas is a community property state);

e. Rights upon bankruptcy of an owner;

f. Right upon termination of employment of an owner (typically for minority shareholders);

g. Right to buy-out owner for any reason upon threshold vote;

h. Deadlock provisions;

i. Push-pull provisions;

[11] Treas. Reg. § 1.162-9.

j. The ability to transfer ownership interests only to family members;

k. In the case of an S-corporation, the ability to restrict transfer of shares to ineligible S-corporation shareholders;

l. Minimum tax distributions; and

m. Drag-along rights and tag-along rights.

(i) Drag-along rights enable the majority owner(s) of a company to force the minority owners to join in the sale of all of the ownership interests in of the company. Buyers typically do not want to buy 90% of the ownership interests (they want 100%). This provision prevents minority owners from killing the deal. The majority owner(s) doing the "dragging" must give the minority shareholders the same price, terms, and conditions as any other selling owner.

(ii) Tag-along rights protect minority owners. They ensure that if the majority owner(s) sells his or her stake in the company, the minority owners will not be left behind and have the right to join the deal and sell their stake at the same price, terms and conditions as would apply to the majority owner(s).

3. <u>Structure of Buy-Outs</u>:

a. Company has first option to redeem and buy-back the ownership interests from owner.

(i) Consideration should be given as to whether this is mandatory or optional. Mandatory buy-backs can cause cash crunch for the company. It is generally recommended that company buy-out is not mandatory.

b. Remaining owners have the option to purchase the ownership interests.

(i) Again, consideration should be given as to whether this should be made mandatory or optional.

(ii) If there are Class A and Class B ownership interests, perhaps only Class A owners are permitted to participate. This prevents Class B owners from increasing their ownership percentage.

4. Calculation of Buy-Out Price. A variety of mechanisms can be used by the parties to establish the price to be paid for an ownership interest in the entity. Examples include:

   a. A mutually agreed specific dollar amount per share, unit, or percentage (to be reviewed and revised annually).

   b. A price per share, unit or percentage based upon a calculation. Popular calculations are multiples of EBITDA or partners' capital divided by number of outstanding shares or units.

   c. An appraised value approach. Fair market value of the company is established and divided by outstanding number of shares or units.

   d. Different values are sometimes used for different situations:

      (i) If a buy-out is triggered due to for-cause termination of employment, book value is often used.

      (ii) If buy-out is triggered due to retirement, a higher value based on a calculation or fair market value is used.

5. Payment of Purchase Price:

   a. Sellers typically want their cash up-front, which can cause cash flow issues for the company. It is generally recommended that the company or the purchasing owners have the option to pay purchase price entirely up front or put a minimum down payment with balance of purchase price paid via a promissory note spread over a certain number of years. For promissory notes, use applicable federal rate as interest rate, which can minimize interest expense for purchasers.

   b. If entire purchase price must be upfront, may prevent company from buying out an owner.

   c. For majority owners, life insurance policies should be maintained by company to fund the purchase price.

F. **Salary Continuation Plans**. In the case of death of the owner, the company continues to pay the owner's family or his estate a certain salary each year for a number of years. The benefits can be paid directly out of the company's funds or can be funded by a life insurance plan.

G. **Trust Issues When Purchases of New Entities Considered**. If Jim and Dave are interested in expansion through the purchase of new entities, then the following issues should be considered if the seller has done estate planning of his own.

1. Dealing with Trustees. If a trust is involved in a sale transaction, then Jim and Dave need to consider the following factors:

   a. Does the Trustee have authority to act?

      (i) Under common law, a party who entered into a transaction with a trust had an affirmative duty to inquire as to whether the Trustee was acting properly.

      (ii) What is the governing law of the trust and the scope of the Trustee's powers and does it remove this duty to inquire?

      (iii) Texas Prop. Code Section 114.081 has lessened this burden and will exonerate a purchaser if he (i) acts in good faith and (ii) obtains a copy of the trust agreement or a certification of trust under Texas Prop. Code Section 114.086.

   b. In the event a beneficiary of a trust brings an action against the Trustee for breach of trust related to the transaction, it is guaranteed that the purchaser will also be pulled into the case as a party-defendant. As such, indemnification provisions should be drafted to provide protection to the purchaser in this scenario.

   c. If the selling trust is not divesting all of its interest in the entity to be sold, how does its structure affect Jim and Dave?

      (i) If the entity is an S-corporation or is expected to make an S-election in the future, does the trust qualify as a shareholder?

      (ii) Who is currently serving as Trustee, his or her relationship with the beneficiaries and how successors are appointed could have a significant impact on management of the company in the future.

2. Section 6324 Lien for Estate Taxes. If an entity or other assets are being purchased from an estate or trust, planners should give due consideration to whether the Section 6324 estate tax lien still applies with respect to the property to be purchased.[12]

   a. Elements.

      (i) The lien applies to all of the assets of a decedent's estate.

[12] See *First Am. Title Ins. Co. v. United States*, 2005-1 USTC ¶ 60,501 (W.D. Wash. 2005) for an example of the Section 6324 estate tax lien at work.

(ii) The lien applies even in the absence of an assessment.

(iii) The lien lasts for 10 years unless the estate tax is paid or becomes unenforceable due to the lapse of time.

(iv) The IRS can seize the property subject to the lien before seeking to enforce the tax liability against the decedent's estate.

b. Exceptions to and Discharge of the Lien.

(i) If the proceeds of the sale are (i) used to pay charges against the estate  administration expenses and (ii) those payments are allowed by the court with probate jurisdiction, then the lien is eliminated.

(1) In states with independent administrations, such as Texas, this will require court involvement where normally personal representatives can act without seeking prior court approval.

(ii) If the personal representative has been discharged from personal liability under Section 2204 of the Code, the sale of the property will divest the lien as to the property and will attach to the proceeds of the sale.

(iii) If the property was the decedent's non-probate property and was sold to a bona fide purchaser, then the lien will be divested as to the transferred property.

(iv) If the property sold is a "security" and the purchaser did not have "actual notice or knowledge" of the lien, then the lien will not attach to the transferred property.

(1) A "security" does not include partnership interests, LLC interests or interests in other unincorporated associations.

(v) A certificate that provides that the lien has been completely discharged or divested as to the property being transferred can be requested from the IRS pursuant to Section 6235 of the Code.

## III. **ROUTE NO. 2: JIM AND DAVE ARE MORE FOCUSED ON SELLING NEWCO AND CASHING OUT**.

A. **Deal Documents**. In most asset sales or stock sales (or sales of ownership interests in LPs and LLCs) of closely held companies, the purchaser will include various provisions in the deal documents to enable purchaser to seek recourse against the selling company and/or selling owners should the purchaser encounter post-closing issues.

1. <u>Confidentiality and Non-Disclosure Agreement</u>. First and foremost, make sure a confidentiality and non-disclosure agreement is signed before any material information is provided to the prospective purchaser.

    a. If the deal goes south during negotiations, the purchaser may be able to use information gained during negotiations against selling company (solicit clients, customers, key employees).

2. <u>Provisions of Purchase Agreement</u>. Purchaser is likely to include substantial representations and warranties in the purchase agreement to bind the selling company and the selling owners personally for breaches of such representations and warranties. Sellers should negotiate to limit exposure under representations and warranties.

    a. Always try to avoid selling owners from having personal exposure to representations and warranties.

    b. Limit survival period of indemnification provisions.

        (i) Set total cap on indemnification exposure (generally a percentage of cash purchase price).

        (ii) Include a basket or non-tipping deductible before any indemnification claims are paid by selling owners.

    c. Watch out for over reaching non-competition agreements.

    d. Watch out for post-closing purchase price adjustments.

        (i) Working capital adjustments.

        (ii) Adjustments for uncollectable accounts receivables.

3. <u>Post-Closing Employment Agreements</u>. Selling owners should negotiate a sweet heart employment agreement or consultant agreement to take effect post-closing.

4. <u>Earnout Mechanisms in Purchase Price</u>. Purchasers are sometimes wary of a target company's performance post-closing and tie part of the purchase price to the performance of the company in the years following the closing.

5. <u>Put Rights</u>. If ownership interests in purchaser are received as part of the deal in lieu of cash, sellers should try to negotiate a put right to preserve cash-out position in the ownership interests received.

B. **Stock Sales**. The current capital gains tax rate of 15% - 20% and avoidance of depreciation recapture makes a stock sale more desirable than asset sales to a seller.

1. Structure of Deals. Most company sales are structured as asset sales, not stock sales. Purchasers typically do not want to buy stock for several reasons:

    a. Want step-up in basis of depreciable assets.

    b. Do not want risk of unknown liabilities of company (potential tax and state law liability concerns).

2. Section 338 Elections. Watch out for Section 338 elections, which treat stock sales as deemed asset sales for federal tax purposes. Makes the deal much more expensive tax-wise. More prevalent with sales of S-corporation stock.

3. Updated Minute Book. Target company must make sure its house is clean. To maximize chances of stock sale, companies need to maintain an updated minute book. As noted above, buyers shy away from stock purchases because of unknown risks of the target company. The lack of an updated minute book (or complete lack of a minute book) is a sign that the company is in bad shape.

C. **Sale of Partnership Interest**. For LLCs and LPs taxed as partnerships for federal income tax purposes, the sale of the ownership interest is generally subject to capital gain treatment.

1. Must watch out for ordinary gain carve out due to Section 751(a) hot assets: (i) accounts receivable, and (ii) inventory.

2. Inventory is generally valued at cost. The main culprit is accounts receivable. Selling owners should limit accounts receivable as of the closing date.

D. **Asset Sale**. The difference in an asset sale between a C-corporation and an S-corporation or a partnership is huge.

1. C-Corporation Double Hit. A sale by a C-corporation of substantially all of its assets followed by a liquidating distribution to its shareholders will be subject to double taxation. The tax is first imposed at the corporate level and again upon the distribution of the proceeds of the asset sale in the form of liquidating distributions. Again, this double hit will be worse if dividend rates increase.

2. Personal Goodwill. If you have an asset sale with a C-corporation, sellers should negotiate part of the purchase price to go to individual sellers for

their personal goodwill (escapes double taxation). Personal goodwill is present when the unique expertise, reputation, or relationship of an individual gives a business its intrinsic value.

3. Non-Competition Agreement. If a non-competition agreement is signed by selling shareholder, should negotiate part of the purchase price to be allocated to and paid directly to shareholder. It will be ordinary income to shareholder, but not subject to double tax since being paid directly to shareholder.

4. Allocation of Purchase Price. It is recommended that that both the selling company and the purchaser be tied down to a tax allocation of the purchase price. This part of the deal is typically the last part of the deal to be negotiated and can be contentious. If seller and purchaser take inconsistent positions on their respective tax returns, it can lead to issues if one party is audited.

   a. Sellers want more value allocated to items such as goodwill to reduce exposure to depreciation recapture.

   b. Purchasers want more value allocated to depreciable assets to increase depreciation of purchased assets.

   c. Form 8594 must be filed by both selling company and purchasing company following the closing. It's a good idea to have a filled out Form 8594 be attached as an exhibit to the purchase agreement, which sets forth the allocation agreed to by the parties.

E. **S-Corporation Planning**. If Jim and Dave are focused on selling Newco, but want to grow the company a bit more to maximize its value before selling it in a few years, they should strongly consider making an S-election. As note above, most company sales are structured as asset sales. The increase in the company's value after the S-election will escape "built-in gain" exposure.

1. Built-In Gains - Section 1374. Upon a company's S-election, Section 1374 subjects the "built-in gain" of company's assets to the C-corporation double tax regime for 10 additional years. The built-in gains tax is essentially the Code's way of trying to prevent a normal corporation from avoiding corporate level taxation by virtue of simply making an S-election.

2. Relief by Congress for Built-In Gains. In recent years Congress has passed legislation to reduce the 10-year period on built-in gains under Section 1374. For tax year 2009 and 2010, the 10-year period was reduced to 7 years. For 2011, the 10-year period was reduced to 5 years. The Taxpayer Relief Act of 2012 did resurrect a 5 year period for 2012 and 2013, but future tinkering by Congress is inevitable.

3. Identifying Built-In Gain Exposure. Upon making an S-election, the company should perform the following actions as of the effective date of the S-election:

   a. Take inventory of all company assets subject to built-in gain (these assets are the company's so called "hot assets").

   b. Determine the difference between the tax basis and fair market value of all its hot assets (this overall accounting gives the company a sense of its built-in gain exposure).

   c. An appraisal by a qualified third party appraiser should be obtained to better protect the company in the event the fair market values are later challenged by the IRS.

   d. For a 10 year period, keep track of when any hot assets are disposed of by the company.



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