Real Life Business Tax, Succession and Planning Topics

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Four Steps to Successful Business Succession Planning:

- Understanding the Need
- Selecting Plan Type
- Valuing the Business
- Financing and Implementation
Some Background Facts:

- 73% of US family businesses admit to not having a documented and robust succession plan in place for senior roles *

BUT:

- 79% of small business owners say that they want to retain their business within the family **
- 70% of second generation family members share the hope of retaining the business within the family **
- So, clearly businesses understand the need...

*Per 2015 PwC Family Business Survey
**Per 1997 Arthur Anderson American Family Business Survey
So What’s Holding Things Up:

- Lack of a clear, well-defined succession plan may create conflict between family unity and the continued success of the business
- Failure to address the issue of who will run the business
- Failure to set realistic expectations
- Not obtaining proper guidance from professionals...this is where we come in!
First: Understanding the Need

- Address the “Human Issues”
- Determine the time frame for a transition
- Make aware of results if there is no “formal” plan
What Are Some of the “Human Issues”?

- Who are the “key” players?
- Has ownership been promised to anyone or promises made about who will succeed?
- Which family members are currently active in the business and what is their commitment and ability?
- Are there family members not involved in the business that want to be involved?
- Do outside successors need to be brought in for the business to continue?
- How will customers react to a change in ownership?
What Is the Time Frame?

- Will there be a gradual transition of ownership or will everything transition on a set date?
- If gradual, will the ownership interest coincide with a change in management and responsibility?
- Will the transition happen at the death of the owner?
- When will customers be informed of the change?
What If There is No Plan?

- Does ownership pass through the estate to unintended beneficiaries?
- Do agreements that were entered into upon the formation of the business lead to unintended results?
- Will the “true” value of the business remain in the family and will the surviving spouse be adequately compensated?
- Will the business be able to continue?
Second: Selecting The Plan - Succession Planning

Alternatives:

<table>
<thead>
<tr>
<th>If you want to:</th>
<th>Lifetime gifts</th>
<th>Bequest</th>
<th>Lifetime sale</th>
<th>Estate sale</th>
<th>Buy-sell agreement</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sell your business interest</td>
<td>Not appropriate</td>
<td>Not appropriate</td>
<td>You may be able to sell your business outright-but there is no guarantee</td>
<td>Your estate may be able to sell your business outright-but there is no guarantee</td>
<td>Buy-sell agreement can be used to guarantee the sale of your business</td>
</tr>
<tr>
<td>If you want to:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Give business to your children</td>
<td>You can control the timing and size of the gifts</td>
<td>You control the size of the gift through your will</td>
<td>Not appropriate</td>
<td>Not appropriate</td>
<td>Not appropriate</td>
</tr>
<tr>
<td>If you want to:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Sell business to your children</td>
<td>Can be used in conjunction with sale</td>
<td>Not appropriate</td>
<td>You can control timing of sale-but sale is not guaranteed</td>
<td>Your child could buy from your estate-but sale is not guaranteed</td>
<td>Buy-sell can be used to guarantee your child’s option to buy your interest</td>
</tr>
<tr>
<td>If you want to:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Minimize value of your estate</td>
<td>Can be used to reduce the value of your estate and maximize gift tax exclusion</td>
<td>Will not minimize value of your estate</td>
<td>You can control timing of sale-but sale is not guaranteed</td>
<td>Value of business must be included in your estate</td>
<td>Value of business must be included in your estate, but the buy-sell can help establish that value</td>
</tr>
</tbody>
</table>
Third: Valuing the Business

Outside Valuation

- Nature and history of the business
- General economic outlook
- Book value of stock and financial condition
- Earning capacity
- Goodwill and other intangibles
- Other stock sales and size of interest to be valued
- Stock value of similar businesses
Third: Valuing the Business

Capitalization of Earnings

- Step 1 - Determine estimated future earnings
- Step 2 - Determine rate of return given the risks associated with the future earnings
- Step 3 – Divide the earnings from Step 1 by the rate of return in Step 2
Fourth: Financing and Implementation

Transfer of Stock

- Borrowing for purchase
- Compensation for services
- Lifetime gifting
- Inheritance
Fourth: Financing and Implementation

Example #1 - S Corporation and Stock Options

Example #2 - Business Transition Using a Grantor Retained Annuity Trust GRAT
S Corporation and Stock Options:

Year End Bonus to Junior Members

- Year end bonus to Junior Members followed by Junior Members purchase of stock from Senior Member:

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<table>
<thead>
<tr>
<th>After Tax Cash</th>
<th>To Buy Stock</th>
</tr>
</thead>
<tbody>
<tr>
<td>Company</td>
<td>Senior Member</td>
</tr>
<tr>
<td>Payroll Taxes</td>
<td>Payroll Taxes</td>
</tr>
<tr>
<td>Income Taxes</td>
<td>Income Taxes</td>
</tr>
<tr>
<td>Year End Bonus Payments</td>
<td>Year End Bonus Payments</td>
</tr>
<tr>
<td>IRS</td>
<td>IRS</td>
</tr>
<tr>
<td>Junior Members</td>
<td>Junior Members</td>
</tr>
<tr>
<td>Taxes to IRS on Capital Gain</td>
<td>Taxes to IRS on Capital Gain</td>
</tr>
</tbody>
</table>
```
S Corporation and Stock Options:  
Calculation of Bonus Available to Buy Stock

<table>
<thead>
<tr>
<th>Description</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bonus to Junior Members</td>
<td>$100,000</td>
</tr>
<tr>
<td>Medicare 1.45%</td>
<td>(1,450)</td>
</tr>
<tr>
<td>FICA Tax (Assumed all under base)</td>
<td>(6,200)</td>
</tr>
<tr>
<td>Federal Tax (Assumed 25% Rate)</td>
<td>(25,000)</td>
</tr>
<tr>
<td>NY Tax (Assumed 6% Rate)</td>
<td>(6,000)</td>
</tr>
<tr>
<td>Add benefit of NY Tax Deduction</td>
<td>1,500</td>
</tr>
<tr>
<td><strong>Net cash available after tax</strong></td>
<td>$62,850</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Description</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less Capital Gain tax paid by Senior Member</td>
<td>$62,850 x 20%</td>
</tr>
<tr>
<td>New York Tax (Assumed 7% Rate)</td>
<td>(4,400)</td>
</tr>
<tr>
<td>Benefit of NY Tax on Federal (at 35% Marginal Rate)</td>
<td>1,540</td>
</tr>
<tr>
<td><strong>Net cash kept by Senior Member</strong></td>
<td>$47,420</td>
</tr>
</tbody>
</table>
S Corporation and Stock Options:

A Viable Alternative - Combine an “S” Corporation with a Plan that Grants Nonstatutory Stock Options to Junior Members

Documents necessary:

• Make election to be treated as an “S” Corporation (already done ?)
• Establish a nonstatutory stock option plan for Junior Members
• Enter into an agreement for Junior Members to buy out Senior Member at a fixed or formula price
S Corporation and Stock Options:

A Viable Alternative - Combine an “S” Corporation with a Plan that Grants Nonstatutory Stock Options to Junior Members

![Diagram]

- Company
- Jr. Member Bonus Diverted
- Senior Member
- Value of Stock Options Granted
- Bonus $
S Corporation and Stock Options:

A Viable Alternative - Combine an “S” Corporation with a Plan that Grants Nonstatutory Stock Options to Junior Members

DECISIONS TO MAKE AT THE BEGINNING:

What is 100% of the company worth?
What % of the company do you want to transfer?
What is “Normal” compensation?

CONSIDERATION OF A “C” CORPORATION CONVERSION:

Appraisal of assets.
Built in gain calculation.
Cash basis receivables.
S Corporation and Stock Options:

Discussion of Nonstatutory Stock Option Taxation

- Governed by Section 83 of Internal Revenue Code
- Important Dates
  - Date of Grant
  - Date of Exercise

If ANY of the following restrictions are attached to the option IRS regulations presume no “Readily Ascertainable Fair Market Value” and cause options to be taxed at Exercise:
  - If option is not transferable
  - If option is not immediately exercisable
  - Neither the option nor the underlying stock have significant restrictions
**S Corporation and Stock Options:**

Discussion of Nonstatutory Stock Option Taxation

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Date options are exercised is **January 2nd, of Year 5 and Jr. Members buy Sr. Member Stock.**

<table>
<thead>
<tr>
<th>Year</th>
<th>Sr. Member</th>
<th>Jr. Members</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year 1</td>
<td>Cash Bonus</td>
<td>Options</td>
</tr>
<tr>
<td>Year 2</td>
<td>Cash Bonus</td>
<td>Options</td>
</tr>
<tr>
<td>Year 3</td>
<td>Cash Bonus</td>
<td>Options</td>
</tr>
<tr>
<td>Year 4</td>
<td>Cash Bonus</td>
<td>Options</td>
</tr>
<tr>
<td>Year 5</td>
<td>Buy out Stock Value</td>
<td>Options Converted to Stock</td>
</tr>
</tbody>
</table>

What happens to Jr. Members in Year 5:

- Huge W-2 as it will include the value of the options.
- Corporation has a deduction for compensation equal to value of options.
- Jr. Member has basis in “S” Corporation Stock equal to the value of option included in the W-2.
- “S” Corporation will most likely show a loss because of big compensation deduction. Loss should be deductible because of basis created for Jr. Members by value of option. Loss will offset the value of the option included in the W-2.
Example #2 Business Transition Using a Grantor Retained Annuity Trust GRAT

The basic operation of a GRAT

• Owner (Grantor) of property (“S” corporation stock) transfers it into the trust

• Trust agrees to hold it for a term of years

• Trust agrees to annually pay grantor a payment based on the FMV of the property at trust creation

• At the end of the term of years property passes to another party
Business Transition Using a Grantor Retained Annuity Trust (GRAT)

Flow Chart of the Operation of a GRAT

1. Sr. owner holds shares of stock
2. Sr. owner transfers shares of S Corporation stock to GRAT
3. GRAT becomes owner of stock
4. S Corporation makes annual distributions

IRS
5. GRAT makes annuity payments to Sr. owner
6. Senior owner pays taxes to the Internal Revenue Service, etc.
7. At the end of the GRAT term the S Corporation stock still held by the GRAT is transferred to the Jr. owner
8. Jr. owner becomes owner of S Corporation stock
Business Transition Using a Grantor Retained Annuity Trust

**GRAT**

The Tax Implications of the GRAT

- The transfer of the property upon formation is a deemed gift not eligible for annual exclusion
- The income earned by the trust property (S Corporation stock) is taxed to the grantor and grantor pays tax without regard to amount of annuity payment
- Grantor must receive a distribution of cash or property equal to the annuity payment
- Trust can include a clause to increase the annuity payment to an amount at least equal to the taxes incurred by the grantor
- The amount of the annuity payment was the amount of tax the owner was going to pay anyhow
Other Possible Options of Succession

Traditional Tools
• 1) Direct sale
• 2) Sub-S buyout
• 3) Stock redemption/cross purchased

Partnership Tools
• 5) Oldco/Newco LLC
• 6) Brother/Sister
• 7) Drop-Down LLC
• 8) JV Partnership

Stock-Based Tools
• 9) Stock Options
• 10) Restricted stock
• 11) Stock bonus

Compensation Tools
• 12) Deferred comp.
• 13) Phantom Stock
• 14) Stock Appreciation Rights

ESOP

Various Trust Options
Thank You!

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