RICHARDS LAYTON & FINGER

The Mid-Atlantic Fellows Institute

Common Business Planning Challenges and Spotting Key Tax Issues for Family-Owned Business Enterprises

Thursday, September 12, 2019

W. Donald Sparks, II, Esquire
Director
Richards, Layton & Finger, P.A.

Choice of Entity / Getting Started

- **<u>Who</u>** is the client?
  - Typically, you already represent the key person for estate planning purposes.
  - If you represent the “entity”, pay careful attention to getting the engagement letter right, with potential conflicts identified.

Choice of Entity / Getting Started

- **<u>What</u>** is the context?
  - New business
  - Existing business reconsidering historic choice of entity
  - Existing owner considering exit timing
  - Retirement, disability or death

Choice of Entity / Getting Started

- **<u>Where</u>** is the business plan?
  - Short and long term business goals
  - Financial modeling, including possible retirement payments or shareholder payouts
  - Growth expectations
  - Expectations regarding continued family involvement in the business

Choice of Entity / Getting Started

- **<u>Why</u>** is the client doing this?
    - Tax motives – income tax, estate tax, new qualified business income (“QBI”) deduction
    - Non-tax motives – Liquidity, retention of key employees, preservation of control

Choice of Entity / Getting Started

- Most family businesses are structured as pass-through entities
  - S corps
  - Limited Partnerships or Limited Liability Companies
  - Individuals doing business through disregarded entities

BUT since the 2017 tax legislation (Tax Cuts and Jobs Act or "TCJA") many pass-through entities are considering conversion to C corporation status as a result of the decrease in the federal corporate income tax rate from 35% to 21%.

Choice of Entity / Getting Started

- Qualified Business Income Deduction
  - The new QBI deduction allows pass-through business owners to claim a deduction for up to 20% of then allowable QBI
    - This has the effect of giving a individual at the top federal rate of 37% a marginal income tax rate of 29.6%, a <u>decrease</u> of 7.4%.
    - **<u>BUT</u>** many pass-through businesses may <u>not</u> qualify for the new QBI deduction
      - There is a carve out for “specified service trades or businesses (i.e, attorneys)
      - There are wage and property basis limitations
    - **<u>AND</u>** 29.6% is still 8.6% worse than the 21% federal income tax rate for C corps.

Factors affecting the analysis of whether to convert a pass-through entity to a C corporation

- The level of future distributions to owners – distributions from a C corp are subject to a second level of tax at the owner level, generally at a 23.8% rate (20% highest marginal qualified dividend federal rate, plus 3.8% net investment income tax rate)
- This mitigates the benefit of the 21% entity-level corporate rate. The more future earnings are intended to be distributed to owners, the less likely the business will decide to convert to C corp status

Factors affecting the analysis of whether to convert a pass-through entity to a C corporation (continued)

- The anticipated growth of reinvested tax savings – the benefit of the lower C corporation rate increases as the growth rate from reinvestment increases and as the holding period increases. The higher the growth rate and the longer the holding period, the more likely the pass-through entity will want to convert to C corp status
- State Income Taxes – Pass-through business owners in states like New York and California pay state income tax on the taxable income at rates above 10%

Factors affecting the analysis of whether to convert a pass-through entity to a C corporation (continued)

- Estate Planning Strategies – Plans involving grantor retained annuity trusts or sales to irrevocable grantor trusts, which often rely on distributions from the business to transfer wealth, generally mitigate against conversion to C corp status. Because C corp distributions are subject to a second level of tax, conversion of a pass-through entity to a C corp will decrease the benefits of the estate tax planning.
- Future Income Tax Changes - Also a factor as many provisions in the TCJA will expire after 2025, including the QBI deduction and the 30% top federal individual income tax rate

Factors affecting the analysis of whether to convert a pass-through entity to a C corporation (continued)

- “Qualified Small Business Stock” under §1202(c) of the Code. A portion or all of the owner’s realized gains upon sale is permanently excluded from the taxable income of the owner (limited to a maximum lifetime threshold) **BUT** the exclusion is only available for stock issued from a C corporation.
- Employee Stock Ownership Plan (“ESOP”) – The unrelated business income rules apply to all ESOPs except S corp ESOP shareholders on income and gain from the pass-through entity.

Factors affecting the analysis of whether to convert a pass-through entity to a C corporation (continued)

- <u>"Hot assets"</u> – i.e., depreciation recapture and appreciated inventory. In the case of ta partnership interest (but NOT C corp stock), gain is recharacterized from long-term capital gain to ordinary income to the extent of the selling partner's share.
- <u>Charitable Contributions</u> – Significant charitable contributions planned by a pass-through business weigh against converting to C corp status (individual owner deduction of up to 60% of AGI vs. C corp deduction of up to 10% of taxable income)
- <u>Percentage Depletion Rules</u> – Favors individual owners of pass-through entities rather than C corps owning interests in oil and gas wells.

Choice of Entity / Getting Started

- If the decision is made not to convert, then the pass-through business needs to review the availability of the new QBI deduction – Code §199A
- See Steve Gorin's materials – pp: 19-38
    - For tax years beginning after 12/31/17 but not beginning after 12/31/25
    - Applies to individuals or trusts that own a partnership interest, S corp. stock or a sole proprietorship
    - Deductions of up to 20% of QBI
    - Causes underpayment penalty to apply at 5% instead of 10%

Choice of Entity / Getting Started

- Types of Income and Activities Eligible for QBI Deduction
  - Must be a qualified trade or business
  - Does not include (i) compensation for services rendered (i.e., salary to S corp owner); (ii) guaranteed payments under §707(c); or (iii) payment for services rendered under §707(a)
  - Does not include specified service businesses (health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any other trade of business where the principal asset of such trade or business is the reputation or skill of one or more of its employees)
  - Taxable income (before QBI deduction) below threshold means that these businesses are not blacklisted

Choice of Entity / Getting Started

- Items Excluded from QBI Deduction
  - Capital gain or loss
  - Dividends
  - Interest income other than interest income which is properly allowable to a trade or business

Choice of Entity / Getting Started

- There is a wage limitation to quality for the QBI deduction. However, it does not apply if taxable income (before the Code §199(a) deduction) is below certain thresholds. The wage limitation are:

For each separate trade or business, the greater of:

- 50% of the W–2 wages with respect to the qualified trade or business, or
- the sum of:
  - 25% of the W–2 wages with respect to the qualified trade or business, plus
  - 2.5 % of the unadjusted basis immediately after acquisition of all qualified property

Choice of Entity / Getting Started

- W-2 wages:
  - Wages subject to withholding and include elective deferral, such as Code § 401(k) and similar plans
  - Must relate to qualified business income
  - Must be properly included in a return filed with the Social Security Administration on or before the 60th day after the due date (including extensions) for such return
- Leasing employees (whether related or unrelated) or using an independent contractor does not help

Choice of Entity / Getting Started

For purposes of the QBI deduction, there is a definition of qualified property:

- Depreciable property:
  - held by, and available for use in, the qualified trade or business at the close of the taxable year
  - used at any point during the taxable year in the production of qualified business income
  - the depreciable period for which has not ended before the close of the taxable year

Depreciable period is greater of 10 years or class life

Land would not count (except for depreciable improvements)

Choice of Entity / Getting Started

- Unadjusted basis
- Appears to require capitalization and therefore disqualify assets expensed under Code § 179
- Bonus depreciation capitalizes and depreciates part immediately
- Using bonus depreciation, most property placed in service after September 27, 2017, and before January 1, 2023 receives an immediate deduction for the <u>entire</u> purchase price. This is simpler and more favorable than Code § 179.

Choice of Entity / Getting Started

- QBI deduction taxable income thresholds
  - \$315,000 - \$415,000 for married filing jointly
  - \$157,000 - \$207,500 for all other taxpayers, including trusts
  - Benefits phase out over each range; phase outs apply cumulatively
- Below the threshold, most ineligible service businesses become eligible and the wage limitations do <u>not</u> apply.

Trusts and QBI

- Grantor trusts are disregarded and their items attributed to their deemed owners.
- The trust and beneficiaries are allocated the various items in proportion to their respective portions of distributable net income ("DNI"), determined after applying the separate share rules, if relevant.
- The Code § 199A deduction is not included in calculating DNI.
- Taxable income thresholds are applied separately at the trust and beneficiary levels.

S Corporation Trusts and QBI

- Electing Small Business Trusts (ESBTs)
  - Trapping income inside ESBT portion (general income tax rule)
- Qualified Subchapter S Trusts (QSSTs)

Choice of Entity / Getting Started

Trusts, QBI, and NII

- Shifting pass-through income to a trust may trigger the 3.8% tax on net investment income (NII) if the business income is passive.
- To avoid the tax on passive business income, the trustee of a nongrantor trust or the deemed owner of a grantor trust must sufficiently participate in the business.
- If the trust is a QSST, then consider having the trustee sufficiently participate, to avoid NII tax in case the business is sold.

Trusts and Depreciation

- Trusts cannot use Code § 179 to expense the cost of purchases of depreciable property (which complicates tax accounting for pass-through entities with trust shareholders). However, presumably the deemed owners of any grantor trust portion can.
- Trusts can use bonus depreciation.
- Beneficiaries may deduct depreciation directly, as a separate K-1 item (“directly apportioned deductions”), except to the extent that the trustee maintains a reserve for depreciation.

Choice of Entity / Getting Started

Key Takeaway

Find out how much, if any, of the analysis has been done by the accountant for the business. If not done by the accountant, determine if the accountant is capable of doing the analysis. If the accountant is capable, have them run the numbers using realistic assumptions blessed by the client.

Wind Down, Sale or Transition of the Business

Wind Down, Sale or Transition of the Business is typically the time when the owner focuses on issues relating to governance, operation and management of the entity

- Why? The lawyer asks for copies of current governance documents, stock ledger or log of ownership, meeting minutes and resolutions regarding current officers, directors or managers, current tax returns , and so on
- Typically, the owner will <u>not</u> have complete and accurate records and the governing documents will be "old and cold" and not reflective of the current situation.

Wind Down, Sale or Transition of the Business

Typically, there is no buy-sell agreement in place and the owner has not focused on key issues that need to be addressed in the buy-sell if the intention is to transfer the ownership of the business to other family members involved in the business or to key employees.

- See case study from ACTEC 2018 Summer Stand Alone attached and pp. 8-42 of Grove, Harrison, Willims materials ("Big Daddy Succession Planning")

Wind Down, Sale or Transition of the Business

There is a checklist of “Buy-Sell Agreement Pre-Drafting Considerations” on pp. 73-74 of the Grove, Harrison, Willims materials, but key is to focus on the following five issues:

- Identity of potential purchaser
- Triggering events
- Restrictions on and nature of transfers of interests
- Valuation / determination of purchase price
- Funding and nature of payments

Wind Down, Sale or Transition of the Business

Identity of potential purchaser:

- Company itself
- Other shareholders
- Cascading rights of first refusal
- Puts and/or calls

Consider: Need to recapitalize business between voting and non-voting interests (see case study)

Consider: If multiple children are involved and senior generation is unwilling to part with control now, how to manage future transfer of control and possible equalization to children receiving non-controlling interests (see case study)

Wind Down, Sale or Transition of the Business

Triggering Events (event which causes option or obligation to purchase to arise)

- Death of owner
- Offer made by third party
- Retirement
- Resignation / Termination
- Disability

Consider: Different purchase price, different funding mechanism, different payout depending on nature of triggering event.

Wind Down, Sale or Transition of the Business

Restrictions on and nature of transfers of interests

- Option vs. obligation to sell or purchase
- All or a portion of owner’s interest
- Restrictions on transferability – e.g., only other shareholders; only other family members; only other employees?

Wind Down, Sale or Transition of the Business

Valuation / Purchase Price

- Agreed upon price updated periodically
- FMV appraisal (take account of discounts or not?)
- Book value
- Amount of bona fide offer by third party
- Formula clause

Wind Down, Sale or Transition of the Business

Funding

- Loan (from company or from third party)
- Cash / Earnings from the business
- Life insurance (issue of matching insurance to value)
- Deferred compensation plan
- Sinking fund

Wind Down, Sale or Transition of the Business

Nature of payment

- Lump sum vs. installments
- Promissory note
- Security

Consider: Differing payment plans for differing triggering events

Wind Down, Sale or Transition of the Business

Ask the Hard Questions:

a) Will the business continue to thrive once the senior generation is gone?

b) Are any of the children willing and able to run the business?

c) Is the business sufficiently liquid to fund a buyout?

d) Is the owner sufficiently liquid to provide for equalization for the children not involved in the business?

e) If the business is not sold or the owner fails to transition, is there a federal estate tax issue and how is the estate tax to be funded?(§6166, §6161, Graegen loans, etc.)

Wind Down, Sale or Transition of the Business

Listen to the answers:

a) Beware of the Endowment Effect, Loss Aversion and Status Quo Bias (see article from Journal of Economic Perspectives)

b) Beware the Apotheosis of the Company (preservation of the Company becomes more important then preservation of family relationships)

c) If you get different answers from different people, consider whether compromise and mutual agreement is possible. If not, reconsider your role in light of your ethical obligations.

d) Importance of establishing short term and long term goals for the business <u>and</u> for the family

Wind Down, Sale or Transition of the Business

Know what you know; Know what you don't

a) Tension between functioning as estate planning attorney for senior generation and as counselor to the family business entity
b) Take advantage of other lawyers who know more about corporate / LLC law than you do; even if such expertise is <u>not</u> available within your firm
c) Have a good working relationship with the Company's accountant and make sure the accountant is capable of accurately running the numbers
d) Engage a competent valuation expert as early in the process as possible. Objectivity as to the current value of the business is critical to the success of the transition plan.

ACTEC 2018 Stand-Alone Program (Hypothetical Fact Scenario)

Family

Big Daddy is 70 years old and has two children, Sonny, age 40 and Dotty, age 45. Big Daddy is divorced from Sonny and Dotty's mother and is remarried to Wendy. Wendy gets along reasonably well with Sonny and Dotty, but also has her own children.

Sonny is married with three children and for the past ten years has run the family business that Big Daddy started. He is a good leader and well respected manager at the Company.

Dotty is married with two children from a prior marriage and plays a small role in the family business. Her husband is an officer in the business but does not always listen with an open mind.

Sonny and Dotty get along well. None of their descendants has the talent or desire to run the family business one day.

Business

The family business manufactures and distributes products, mainly on a rent-to-own basis and is financed by a $15 million line of credit. The Company has plants and distribution facilities in several states. The business is worth about $20 million. Big Daddy owns 81%, Sonny owns 10% and Dotty owns 9%. The basis of the business' assets exceeds its liabilities by $10 million.

The Estate Plan

Big Daddy is willing to give or sell all of his interest in the business to Sonny and Dotty now so long as Big Daddy can net at least $2 million from the transaction. Big Daddy has $4 million of nonbusiness assets and a $3 million life insurance policy. Big Daddy intends to leave the business equally to his children. Sonny will own a majority of the stock and be able to run the Company. Big Daddy also plans to leave one-half of his nonbusiness assets to his children with the remainder of his nonbusiness assets to Wendy.

Wendy does not have substantial assets of her own other than her interest in their joint residence valued at $1 million. Wendy plans to leave her assets to her children.

ACTEC 2018 Stand-Alone Program (Hypothetical Fact Scenario) continued

Non Family Shareholder

Big Daddy, Sonny and Dotty recognize that the family business needs some internal financial process and decide to give their outside CPA a 5% stake in the business in exchange for the outside CPA becoming the family business' internal CFO. They need help deciding how best to do this.

Growth of the Business

Over time the business expands adding manufacturing and distribution facilities in separate real estate LLCs.

Big Daddy's Death

Fast forward seven years to Big Daddy's passing. Several issues arise:

- Sonny, Dotty and CFO periodically fly in the airplane that is owned by the family business to visit facilities and are concerned about simultaneous death scenarios.
- Sonny and Dotty agree to award CFO another 5% interest in the business. If the natural order of deaths occurs, life insurance buy-sell agreements will cash out Dotty's estate, then Sonny's estate, leaving CFO owning 100% of the Company.
- All expansion is paid for by borrowing: the family business distributes as much of its earnings as its lender will allow.
- Sonny, Dotty and CFO believe that the family business is worth $30 million but cannot find a buyer to pay that much. Selling for even that much would reduce annual cash flow to the shareholders significantly because marketable securities do not have as large a total return as this family business.

Biography

W. Donald Sparks, II

Director

302-651-7758

302-498-7758

Sparks@RLF.com

Mr. Sparks practices primarily in the areas of estate planning, estate administration, tax-exempt organizations and fiduciary litigation. He received his B.A. degree, summa cum laude, from Dartmouth College and his J.D. from Yale Law School where he served as a Senior Editor of the Yale Law Journal. He clerked for Judge Caleb Wright of the U. S. District Court for the District of Delaware. He is a fellow of the American College of Trust and Estate Counsel ("ACTEC"). He is a member of the Real Property and Trusts Section of the Pennsylvania Bar Association and the Tax and Estates and Trusts Sections of the American Bar and Delaware Bar Associations. He is a past chairman of the Delaware Bar Association Section of Taxation, a past Chairman of the Delaware Bar Association Estates and Trusts Section, and a past Chairman of the Estate Planning Council of Delaware, Inc. He is a frequent speaker and author on estates, trusts, and other tax-related topics having appeared for ACTEC, The University of Miami Estate Planning Institute, the Delaware Tax Institute and the Delaware Bankers Association Trust Conference. He has also served as a Board member and officer of numerous charitable organizations, including the Brandywine Conservancy & Museum of Art.