

Business Succession: The No Tax Solution

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Business Succession. Business succession relates to the process by which the owners and executives of closely-held companies undertake the following:

- * Sell or transfer of ownership interests
- * Develop successor management
- * Optimize wealth and liquidity

Ownership transfers may include cross purchase agreements with other owners, family trusts or limited partnerships, redemption agreements among owners and the companies, sales to successor management, sales to outside parties, stock for stock exchanges, initial public offerings or employee stock ownership plans. Quality successor management can assure business continuity and survival. Effective financial planning can improve the financial security upon the sale or transfer of ownership interests by minimizing taxes on personal income, capital gains, gifts and estates. This presentation will summarize the methods by which the following objectives can be achieved by the owners and executives of closely-held companies:

- * Sell the business and pay no taxes on the gains
- * Pay substantially no estate taxes regardless of the value of the business
- * Sell the business and retain family control
- * Operate the business with no U.S. or state income taxes on the profits

All of these tools have been available prior to passage of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA). However, application of these tools alone will not yield optimal results unless used in specific combinations and under certain circumstances.

Employee Stock Ownership Plans. An employee stock ownership plan (“ESOP”) is special type of stock bonus (and profit sharing) pension plan qualified under Section 401(a) of the Internal Revenue Code (the “Code”) and Section 4975(e)(7) of the Code. As such an ESOP is exempt from the diversification requirement of Section 404(a)(1)(C) of the Employee Retirement Income Security Act (“ERISA”) but not from the prudence rules of ERISA Section 404(a)(1)(B). An ESOP is also exempt from certain prohibited transactions under ERISA Section 408(b) and Code Section 4975(d), including loans from the sponsor company.

A major benefit for company owners selling to an ESOP is that they can cash-out and defer or exclude capital gains taxes (and related state income taxes) on gains from stock sales to an ESOP under Code Section 1042 by investing the sale proceeds in the securities of any U.S. operating company within one year after the date of sale to the ESOP. Certain conditions apply, including certain allocation restrictions to selling owners under Code Section 409(n) and the requirement that the ESOP must hold at least 30% of the company’s stock after the sale. Owners or managers

can direct the voting of stock in the ESOP and employees benefit from the continued existence of the company and from the opportunity to share in its equity value.

If a bank loan (or internal loan) is used by the ESOP to purchase the stock, loan principal payments are pre-tax up to 25% of eligible compensation. Dividends of a reasonable amount on stock in an ESOP are also pre-tax. Further, if it is prudent to do so, an existing pension plan, such as a profit sharing plan or 401(k) plan, can be restated as a ESOP and a prudent amount of the plan assets from company contributions can be used to acquire stock. If the 401(k) features are retained with the ESOP, the plan is also known as a “KSOP.”

An ESOP can be used to acquire other companies on a pre-tax basis and, thereby, substantially reduce acquisition costs. The owners of the company being acquired may also be eligible to defer or exclude taxes gains realized from the sale to the ESOP of the acquiring company, resulting in benefits for both the sellers and the buyers.

As the owner of the stock of a Subchapter S corporation, ESOPs have a special exemption from taxes that would normally apply to the owners of Sub S corporations, including the tax on the unrelated business income tax (“UBIT”) that would apply to any other qualified plan that owns the stock of a Sub S corporation under Code Section 512. Thus, a 100% S corporation ESOP would pay no income taxes either at the company level or at the shareholder level. However, owners selling to the ESOP of a Sub S corporation are not eligible for the Code Section 1042 tax free rollover and certain allocation restrictions may apply under Code Section 409(p).

Family Limited Partnerships. A family limited partnership (“FLP”) is a financial planning tool that can assure the orderly and controlled transfer of an asset, such as company stock or real estate, to family members free from attachment by creditors and at a discounted value for gift and estate tax purposes. As to a closely-held or family enterprise, the following procedures apply:

- * The owners (i.e., the parents) establish a limited partnership with the owners, directly or through an entity such as a limited liability company (“LLC”), serving as the general partner and the children as the limited partners that would own all or substantially all the assets of the FLP. This should be accomplished at least one year prior to the date of death of the parents.
- * The owners transfer by gift all or a majority of their company stock to the FLP. The maximum gift, without reducing the unified credit of the parents, would be \$20,000 per year per child (\$10,000 per parent per child with any excess applied to the unified credit). As an alternative, the parents could exchange the company stock for the limited partnership interests in the FLP. In turn, the FLP interests could be gifted to the children over a period of years.
- * The company establishes an ESOP which purchases a majority of the company stock from the FLP at controlling interest price. The ESOP now holds a majority of company stock.
- * If the FLP holds the company stock for three years prior to the sale to the ESOP, the

partnership should be eligible to defer capital gains taxes under Section 1042 of the Internal Revenue Code (the “Code”). Under Technical Advisory Memorandum 9508001 issued by the IRS in late 1994, a partnership entity can qualify as the electing “taxpayer” for purposes of Code Section 1042. Because of the ownership attribution rules of Code Section 318, the family members may still be subject to the restricted allocation rules of Section 409(n) if they are participants in the ESOP.

For Federal estate and gift tax purposes, the FLP interests are subject to a discount because the interest holders, the limited partners, do not exercise control over the FLP and do not have a controlling interest in the FLP. Thus, either a lack of marketability discount or a minority interest discount, or both, would be applicable. Further, the FLP interests held by the limited partners are not subject to attachment by creditors until such time as the FLP dissolves. Any earnings or distributions to the limited partners, however, would be subject to creditor attachment.

The rules relating to family limited partnerships are complex and beyond the scope of this article. During 1997 the IRS issued several letter rulings that disallowed valuation reductions for several FLPs in which, among other matters, the FLPs were established in anticipation of death or were funded primarily with residential property. Thus, it is essential that a FLP have a valid business purpose, such as the orderly transfer of ownership or control of a closely-held business, that there be a transfer of capital interests in the partnership and that the FLP be established a reasonable period of time prior to the death of the transferor of the asset.

As an alternative to the use of a family limited partnership in the preceding example, a limited liability company (“LLC”) could be used. One significant difference is that, with an LLC, there is no personal liability to the designated manager as there could be with the general partner of a limited partnership. However, as noted above, an LLC could be a general partner.

Charitable Remainder Trusts. Transfers of interests in a closely-held business to a charitable organization can achieve significant benefits, such as an immediate charitable deduction and an income stream if a qualified trust is utilized in connection with the donation. In order to be effective for both the charity and the donor shareholder, a donation of stock, whether direct or through a charitable remainder trust (“CRT”), would need to be followed by a sale or “cash in” of the stock by the CRT.

A donation followed by a redemption, however, may be characterized by the IRS as a taxable constructive dividend to the shareholder. If the donor shareholder is seeking to generate an income stream from the stock in the CRT, generally the closely-held stock must first be sold by the CRT in order to generate income sufficient to meet the income objective.

Although there are a number of methods through which a CRT can “cash in” the stock of a closely-held company, (e.g., sale to other shareholders or redemption by the company), the CRT cannot be required to sell the donated stock nor be compelled to invest in other assets. Unlike other disposition methods, an ESOP creates a market for the closely-held stock in the CRT using pre-tax dollars. As with a CRT, an ESOP cannot be required to purchase the stock from the CRT nor be compelled to sell any other assets.

A “CHESOP” is a CRT/ESOP transaction in which the CRT sells the stock received from the donor shareholder to the ESOP of the issuing company. A “CRESOP” is a CRT/ESOP transaction in which the shareholder first sells the stock to the ESOP and then makes a donation of the sale proceeds to the CRT. If the latter, the selling shareholder may also elect to defer or eliminate recognition of any otherwise applicable capital gains taxes under IRC Section 1042 by investing the sale proceeds into a “rollover portfolio” in the securities of any U.S. operating company within one year after the date of sale to the ESOP.

Because donation and transfer of the rollover portfolio to a CRT does not result in a taxable event, so as to trigger recapture of the gain, gift planners often consider them to be a preferred asset for funding a CRT. The gift creates an immediate deduction while funding a major charitable gift. Since the CRT is a tax-exempt entity, it can sell the rollover portfolio at any time without taking into account capital gains taxes as part of the investment decision to provide an income stream to the selling shareholder. In addition, because a tax-free sale to an ESOP can occur in several stages (assuming that at least 30% is sold in the initial transaction), flexibility for financial planning is possible as long as the design of the CRT is a unitrust.

While an analysis regarding the design of the CRT is too complex for this overview, a CRT can be drafted as a unitrust which permits flexibility in planning donations and income targets. Distributions are based on performance as a fixed percentage with permissible “make-up” contributions (preferable for non-liquid investments). The higher the unitrust payment, however, the lower the charitable deduction.

The annuity type CRT requires a specific payment each year but prohibits additional donations (may be preferable for assets which fluctuate in value). Accordingly, the annuity form is more conservative since it eliminates the possibility that the income stream will increase. It also, however, cannot provide a hedge or protection against inflation.

Irrevocable Life Insurance Trust (ILIT). Normally, the proceeds of life insurance are included in the estate of the insured. The typical whole life policy includes a term insurance (death benefit) component and a cash value (fixed return) component. The typical variable life policy includes a term insurance component and an investment (variable return) component.

At the corporate level, life insurance premiums are paid with after tax dollars and the death benefit is subject to the alternative minimum tax (AMT). At the individual level, premiums are paid with after tax dollars and named beneficiaries generally pay no income taxes on the proceeds. However, the proceeds are included in the estate of the insured if (a) the estate is the beneficiary or (b) the insured has incidents of ownership such as the power to change the beneficiary, change the ownership, cancel the policy or withdraw the cash value.

The solution is a perfected irrevocable life insurance trust (“ILIT”) which owns the policy with the proceeds payable to the trust upon the death of the insured. The ILIT could own a new policy or an existing policy could be transferred at least three years prior to the death of the insured.

Premiums are generally paid with after tax dollars and may be subject to the gift tax. Because there are no incidents of ownership and control, the proceeds will not be included in the taxable estate of

the insured. An ILIT is frequently used as a family wealth restoration vehicle in connection with a charitable remainder trust (CRT) or to pay estate taxes of the insured.

Qualified Small Business Stock (QSBS). Code Section 1202 contains a provision that allows owners of closely-held companies to exclude from taxation up to 50% of any capital gains realized upon the sale of qualified small business stock (“QSBS”). Numerous restrictions apply to this exclusion, including the following: QSBS stock must have been held for at least five years by the electing seller; the company must be a Subchapter C corporation engaged in the active conduct of a trade or business; the company cannot have gross assets in excess of \$50,000,000; the exclusion for any tax year cannot exceed the greater of \$10,000,000 or 10 times the adjusted basis of the QSBS. If capital gains are \$10,000,000 on a stock sale of \$15,000,000, the exclusion would be \$5,000,000 and total capital gains taxes paid, at a 20% rate, would be \$1,000,000.

Recapitalizations. In many situations, it may be advantageous for the capital structure of a corporation to be restructured in conjunction with the business succession or financial planning of the owners. In a recapitalization, which is a tax free reorganization supported by a valid business purpose, the company’s shareholder can accommodate the following:

- * Non-voting common or preferred stock for family members not active in the business;
- * Transfers of some or all stock to trusts or to a family limited partnership (FLP) as part of an estate reduction plan or asset protection plan;
- * Tax free gifts of certain amounts or classes of stock, whether outright in trust or held in an FLP, to family members up to the annual limit or the unified credit limit;
- * Convertible preferred, or common with superior dividends, to enable the company to pay pre-tax dividends only on stock in an ESOP to service the debt used to purchase the stock.

Without the restructuring, equal dividends would have to be paid on all shares which could be a financial burden restricting the company’s business activities. The recapitalization serves to reduce the cash flow needs of the corporation and satisfy the business purpose requirement for a tax free transaction. Accordingly, the exchange does not result in recognized gain or loss and the substituted stock retains the same basis and holding period as the original ownership interest.

Recapitalizations must take into consideration the present value of the dividend stream in determining the exchange ratio. In a typical transaction involving family members, the outstanding shares would be converted to a class A common stock with a reasonable dividend rate through an amendment of the charter documents. The selling shareholder (i.e., a parent), would sell a portion of his/her Class A stock to the ESOP and the deductible dividends would be used to service the ESOP debt. The remaining stock would be exchanged for shares of a “cheaper” class of common stock to facilitate transfers of interest to family members either through direct gifts or the FLP mechanism, using the annual \$10,000 exclusion of the increased unified credit exclusion. Where family members intend to remain in the business, recapitalization may also be combined with family-owned business exclusion to further facilitate financial planning.

Qualified Family Owned Business (QFOB). On the estate planning side of business succession, alternatives for the owners of closely-held companies include the qualified family-owned business (“QFOB”) exclusion and installment payments for estate taxes. As to the latter, the installment

estate tax provisions of Code Section 6166 permit payment over a 2 - 15 year period under certain circumstances.

In connection with the QFOB exclusion under Code Section 2057 (added to the Taxpayer Relief Act of 1997), the ownership, liquidity and participation requirements are technically complex and may significantly diminish the use of the exclusion. In general, a qualified estate may exclude a maximum of \$675,000 from the taxable estate adjusted by the unified credit exemption (\$1,000,000 for both 2002 and 2003). Thus, \$675,000 is the maximum deduction.

In order to be qualified family-owned business, the ownership requirement is that at least 50% is held by one family, 70% by two families or 90% by three families. The business must satisfy a liquidity requirement by which the aggregate value of the interests passing to qualified heirs (members of the decedent's family and active employees with at least 10 years of service prior to the decedent's death) must exceed 50% of the adjusted gross estate. In addition, the decedent, or a family member, must have owned, and materially participated, in the business for at least 5 of the 8 years preceding the death and a family member must continue to participate for at least 5 years in any 8 year period within the 10 years following the death.

Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) repealed Section 2057 effective December 31, 2003.

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Mr. Jochim is a former Manager of Industrial Development for the Ohio Department of Development and former General Counsel of Ironton Iron, Inc., an employee-owned company. He is currently adjunct professor of corporate finance at the Capital University School of Law and is a former adjunct professor of business policy at The Ohio State University.

The nature of his practice has required Mr. Jochim to develop expertise in the negotiation and structuring of business transactions as well as in several substantive areas of law including corporate, employee benefits, securities and corporate tax. He has assisted clients in developing and implementing professional boards of directors and has lectured frequently to business and trade organizations on corporate governance.

Mr. Jochim is the author of *Employee Stock Ownership and Related Plans*, published by Greenwood Press in 1982. His articles on business transactions and corporate finance have been published in *The Academy of Management Review* (July, 1979); *Personnel* (November - December, 1978); *Public Utilities Fortnightly* (January 21, 1982), *Ohio Business* (October, 1988), *The Journal of Employee Ownership Law and Finance* (Fall, 1998), *Taxation for Accountants* (July, 1998) and *Taxation for Lawyers* (September-October, 1998).

Tim Jochim has been active in the Columbus Bar Association and the American Bar Association. He is co-founder of the Ohio Chapter of The ESOP Association and a member of the legislative committee of The ESOP Association. He has also been a candidate for U.S. Congress from Ohio and has been recognized in *Marquis Who's Who in the Midwest* and in *Benton's Who's Who*.

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