

The Family Game of Thrones: How to (and How Not to) Transition a Closely Held Business

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Introduction

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- Practice Area Focus:
 - Tax and corporate matters for family-owned or closely held businesses.
 - Design and implementation of business succession plans or business separation transactions.
 - Formation, governance, reorganization and internal restructuring of corporations, partnerships and LLCs.
 - Structuring, negotiating and implementing M&A transactions.
- Education:
 - Georgetown University Law Center, LL.M. in Taxation with Distinction.
 - Southern Methodist University School of Law, J.D.

Overview

- Importance of Business Succession Planning
- Events Leading to a Business Transition
- Current Organization Structure and Tax Status of the Business
- Recapitalizations and Share Exchanges
- Transitioning the Business
- Buy-Sell Agreements (or Similar Agreements)
- Incentive Share Plans & Phantom Stock Plans
- Exiting the Business

Importance of Business Succession Planning

- 2 Primary Types of Exits:
 - Keep the business and focus on the next generation of owners (i.e., traditional business succession planning); or
 - Selling the business (or a majority of the business).
- An exit strategy that is developed and implemented early provides a smooth succession and/or sale of the business.
- When deciding to exit the business, consideration needs to be given to many factors such as methods to transition the business to the next generation of owners, the structure of buyouts, calculation of the purchase price, stock vs. asset sales and sufficient liquidity.
- This presentation focuses on keeping the business and focusing on the next generation of owners, but will touch upon selling the business and other related topics.

Events Leading to Business Transition

- Sample of events leading to business transitions and/or exits:
 - Estate tax exposure
 - No succession plan (no children or family members involved in the business)
 - Death
 - Disability
 - Divorce
 - Disagreement among family on the governance/future of the business
 - Sale to third party (approached out of nowhere by a buyer)
 - Loss of key personnel
 - Desire to retire
 - Involuntary transfers

Current Organizational Structure and Tax Status of the Business

- Common business entities:
 - Limited Liability Companies
 - Limited Partnerships
 - S-Corporations
 - C-Corporations

General State Law Considerations when choosing a Business Entity

- Is the company organized properly for state law purposes?
- Has the company outgrown its current company structure?
 - Is the company suitable for a single entity structure or holding company structure?
- What is the best state to organize the company under?
 - Delaware or another state?
- Does the current structure provide adequate liability protection?
- Is the company structured in a way that facilitates business succession or a sale?

Limited Liability Company Considerations

- Most popular form of entity, but also misunderstood.
- Member-Managed vs. Manager-Managed.
- Potential self-employment tax exposure.
- Series LLCs
 - A Series LLC is a newer form of business entity in which each LLC is a part of a series of entities under a single-umbrella entity.
 - The LLCs may have different assets, members, and managers.

Limited Partnership Considerations

- Administratively burdensome because of two-tiered entity structure.
 - Misunderstood in the context of having two types of partners.
 - Prone to documentation errors.
 - Possibility for liability exposure.
- Still see LPs with individuals as general partners creating liability.
- A LP is generally taxed as a pass-through entity.
 - LPs taxed as partnerships are commonly being converted to LLCs.
 - Exposure to Net Investment Income Tax (“NII”).
 - Exposure of limited partners to liabilities if they are active.
 - Dysfunction between self employment tax planning and NII tax planning.

S-Corporation Considerations

- Provides tax planning opportunities for self-employment tax but:
 - Lack flexibility in ownership (strict ownership requirements).
 - Occasionally under attack from proposed legislation.
 - Lack flexibility in distributions.
 - Hurdle for venture capital or private equity investors.
 - More difficult to facilitate estate or succession planning:
 - FLP structure cannot be implemented.
 - Only certain trusts can be a shareholder.
- Taxed as a pass-through entity for federal income tax purposes and is typically not subject to an entity-level tax.
- Minimum distributions may be made to each shareholder to pay their share of taxes.
- Commonly implement “F” reorganizations to facilitate a sale of a business or issuing other classes of ownership (for example, a profits interest).

C-Corporation Considerations

- A C-Corporation is subject to “double taxation” of corporate earnings.
 - Current corporate tax rate: 21%
 - Subject to NII.
- A C-Corporation is subject to the Accumulated Earnings Tax.
- Difficult to implement long-term estate or succession planning.
 - If you implement an FLP and later desire an S election, the FLP must be undone. How does that affect prior discounts taken?
 - If you have different classes of stock and later desire an S election, that raises hurdles.
 - Subject to built-in gains.

Beware of Charging Orders

- What is a Charging Order?
- Charging Orders for Corporations create the potential possibility for creditors to actively participate in the business.
- Limited Liability Companies provide protection against charging orders.
- Limited Partnerships generally offer the same protection features as a Limited Liability Company.

Recapitalizations and Share Exchanges

- What is a recapitalization and why is it needed?
 - The myth of majority ownership.
 - What constitutes management control vs. total control over a business entity?
 - Multiple classes of ownership commonly used where a family treats children equally, but not all children are involved in the business.
- Typically done to change the capital stock structure from one class of common stock to Class A Voting common stock and Class B Nonvoting common stock.
 - Allows shareholders to gift and/or sell shares to family members without giving up control.
- Must be careful when an S-Corporation undergoes a recapitalization.
 - Only difference can be voting rights with multiple classes of stock.
- A share exchange is similar to a recapitalization but is used in situations where a corporation already maintains Class A Voting Stock and Class B Nonvoting stock.
- Similar recapitalizations can be done with LLCs and Limited Partnerships
 - Typically, easier to do with LLCs and LPs.

Transitioning the Business

- If the value of a company exceeds, or is expected to exceed the estate exemption, consider gifting or selling ownership interests in the company to the next generation of owners.
 - Current estate and gift tax exemption amount: \$12,920,000 per person.
 - If there is a limited remaining exemption amount, consider sales.
 - Don't unnecessarily waste the exemption amount if debt can be utilized.
- Gift vs. sale when transferor retains an interest in the business entity: the Powell Case Conundrum.
 - Risk of assets being pulled back into estate.
 - Estate of Nancy H. Powell vs. Commissioner and related Section 2036 issues.
 - If sale route is utilized, are intentionally defective grantor trusts (IDGTs) being used as the buyer?

Transitioning the Business (Cont'd)

- If an ownership interest is transferred, recipient should agree to be bound by the entity's governing documents.
 - Issue of enforcing recipient's ownership when received as a result of the death of owner. What if they argue they were not a party of the governing document?
- A company may wish to issue Class A Voting shares and Class B Nonvoting shares to retain business control of the company, while simultaneously transferring a significant value of the business.
 - Considerations should be given to recapitalizations and share exchanges as described previously.
- If a company wishes to retain key employees, the company can issue or sell nonvoting shares to key employees without giving up control.
 - Phantom Stock Plan or Incentive Unit Plans can be implemented if the Company does not wish to sell or issue shares (Further discussed below).

Buy-Sell Agreements: Overview

- What is a “Shareholders Agreement” or “Buy-Sell Agreement”?
- Customized document that is typically different for every client. Should be tailored to the needs and circumstances of the business and the owners.
- Essential to update the agreement when provisions are outdated.

Buy-Sell Agreements: General Provisions

- Restrictions on transfer provisions
- Rights of first refusal
- Rights upon death or disability of an owner
- Rights upon divorce of an owner
 - Community property or Separate property state
- Rights upon bankruptcy of an owner
- Rights upon termination of employment
- Right to buy-out owner for any reason upon threshold vote
- Default owners (ownership subject to being seized or involuntary transfer)
- Deadlock provisions or push-pull provisions
- Minimum tax distributions
- Drag-along rights and Tag-along rights
- Restrictive covenants (confidentiality, non-competition, non-solicitation)

Buy-Sell Agreements: Transfer Provisions

- Important to accurately define important terms such as:
 - Permitted Transfer
 - Example definition using GOT Characters: “Permitted Transfer” Subject to the terms and conditions set forth in [Articles/Sections _____ and _____,] all or any portion of the Units of a Member may be Transferred at any time to: (a) any Person with the prior written consent and approval of the Board of Managers and a Required Interest, (b) Eddard, (c) Catelyn, (d) any Descendants of Eddard and Catelyn, (e) a Qualifying Trust, or (f) if such transferring Member is a Qualifying Trust, the Beneficiary or Beneficiaries.
 - Beneficiary
 - Example definition: "Beneficiaries" mean those persons to whom the trustee of a trust is required to or may currently exercise its discretion to distribute income and/or principal from such trust.

Buy-Sell Agreements: Transfer Provisions (Cont'd)

- Descendants
 - Example definition: “Descendant” means the lineal blood descendants of any degree of the ancestor designated; provided, however, such references shall include, with respect to any provision of this Agreement, descendants who have been conceived at any specific point in time relevant to such provision and who thereafter survive birth; provided further that a child adopted prior to attaining age nineteen (19) and such adopted child’s lineal descendants by blood or adoption shall be considered under this Agreement as lineal blood descendants of the adopting parent or parents and of anyone who is by blood or adoption a lineal ancestor of the adopting parent or of either of the adopting parents.
- Qualifying Trust
 - Example definition using GOT Characters: “Qualifying Trust” means a trust of which (a) Eddard, (b) Catelyn, and/or (c) any Descendants of Eddard and Catelyn constitute all of the Beneficiaries thereof.
- Should the definition of Qualifying Trust include spouses or spousal benefit trusts?
- Who is permitted to be the trustee of a Qualifying Trust?

Buy-Sell Agreements: Structuring the Buyout

- Generally, the company has the first option to redeem and buy-back the ownership interests from the owner.
 - Should the buy-back be mandatory or optional?
- Then, the remaining owners have the option to purchase the ownership interest.
 - Again, consideration should be given whether to make this mandatory or optional.
 - If there are multiple classes of stock, consider restricting certain classes of stock from purchasing the ownership interest.
 - Reclassification event: If there's voting and nonvoting shares, and an unexpected event occurs where there's no voting shares left, what happens? This unforeseen situation should be addressed.

Buy-Sell Agreements: Calculating the Purchase Price

- Commons ways to calculate the purchase price:
 - A mutually agreed specific dollar amount per share, unit or percentage. Be wary of these as they tend to get outdated.
 - Option to use specific price, but then defer to valuation if specific price is not updated annually.
 - A price per share, unit or percentage based upon a calculation. Be wary of formulaic approaches becoming outdated over time.
 - An appraised value approach (qualified third party valuations are recommended). Most popular approach.
- Different calculations may be used for different buy-out situations.
 - Lower price upon certain buyout event such as termination for cause. Be wary that different pricing mechanics may lead to enforceability issues.

Buy-Sell Agreements: Payment Terms and Funding Mechanisms

- Should you pay the purchase price entirely up front or pay the balance of the purchase price over time via promissory note?
 - What interest rate should be used? AFR?
- If the owner is deceased, businesses often require the use of life insurance to fund some, if not all, of the purchase price.

Incentive Share Plans & Phantom Stock Plans

- If a company wishes to retain key employees, but the company does not want to give real equity to such key employees, an increasingly popular option is implanting incentive share plans (more commonly known as “Phantom Stock Plans”).
- “Phantom shares” are hypothetical shares that represent the value of the company’s stock.
 - The shares do not represent true equity in the company.
 - May be converted at a later date into actual stock, cash or both when a “payment event” occurs.
- Considered compensation by the company to the participants.
 - Ordinary income reported on W-2 and subject to payroll taxes (no capital gains)
 - Company gets a deduction.

Incentive Share Plans & Phantom Stock Plans (Cont'd)

- “Phantom” Shares do not have voting rights.
- Allows the incentive plan to be tailored to fit the objectives of the company in terms of the amount of compensation, and the method and timing of payments.
- The plan permits an employee to participate in growth without diluting shares, or providing voting or liquidating rights.
- Incentive Plans are typically customizable for various events such as:
 - Company sale event
 - Death
 - Disability
 - Retirement
 - Distribution equivalent rights

Exiting The Business

- An exit strategy created in advance will ensure a smooth sale of the company.
- Will the sale of the business be a stock sale or asset sale?
 - In today's PE driven world, it's not so simple. Some sale structures are a blend of both.
 - Rollover equity? Do all family members receive it?
 - Are there any board seats associated with rollover equity?
- The problem with selling a C-Corporation:
 - Double taxation plus NII Tax.
 - 5 year built-in gain rule if an S election is made.
 - Is personal goodwill a viable option and what are the IRS risks involved?

Exiting The Business (Cont'd)

- Selling an S-Corporation requires multiple hurdles due to the restrictions of the shareholders. Consideration should be given to contributing the assets and business to a new LLC or Partnership when selling the business.
 - Consider an F Reorganization.
- Equity sales that are treated as asset sales:
 - 338 elections
 - F Reorganizations
 - Importance of purchase price allocation
- Provisions in the Buy-Sell agreement should be tailored to allow the owners to completely exit the business.
 - Considerations should be given to:
 - Authority to sell the business.
 - Drag-along and Tag-along rights.

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