

# **SUCCESSION PLANNING FOR PRIVATE BUSINESSES: IT'S NEVER TOO EARLY**

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## **I. INTRODUCTION**

A. Goal – To provide a basic understanding of principal succession planning concerns through compilation of applicable technical information modules and analysis of planning techniques by reference to actual case studies. The intended audience is private business owners. No prior knowledge or experience of the topic is required.

B. “The Envelope”- Publicly held businesses

1. Succession planning

2. Board of Directors duty

a. Protect shareholders

b. React to marketplace

c. Assure employees, suppliers, creditors and customers

C. Privately held businesses

1. Same as publicly held businesses PLUS

2. One size doesn't fit all

3. Family/partner relationships

4. Tax considerations – income, gift, estate

D. Privately held business statistics

II. AUDIENCE DEMOGRAPHICS – Who are you? What do you know?  
What do you need to know?

## **III. TECHNICAL MODULES**

A. Business Structures and Relevant Considerations

1. Sole Proprietorship – a single business owner operating in his/her individual capacity
2. Corporation – a separate business entity recognized under state laws
  - a. Regular corporation – a business entity formed in accordance with state law; one or more shareholders with limited liability for obligations of the entity; multiple planning arrangements for capitalization; separately taxed on profits and distributions
  - b. Subchapter S corporation – a corporation (as above) but subject to specific rules and limitations of for income tax purposes; limited number and types of shareholders; single class of stock; generally no corporate level tax; passthrough taxation to shareholders.
3. Partnership – a separate business entity composed of associates acting together to produce a profit
  - a. General Partnership
    - i. Standard General Partnership – a business entity organized under state law (no written agreement is required) composed of at least two partners, each of whom have total liability for all obligations of the entity; no entity level taxation, partners are taxed on allocable shares of income; distributions are not taxable (unless exceed tax basis of partnership interest – see below)
    - ii. Limited Liability Partnership – same as standard general partnership except, by filing in state, liability of general partners are limited
  - b. Limited Partnership
    - i. Standard Limited Partnership – a business entity organized under state law by filing; written agreement is required; composed of at least two

partners, one of which is general partner (same obligations as standard general partnership) and one of which is limited partner with limited liability; no entity level taxation; partners are taxed on allocable shares of income

- ii. Limited Liability Limited Partnership – same as standard limited partnership except, by filing in state, liability of general partner is limited

4. Limited Liability Company – a separate business entity organized under state law

- a. Single Member – a business entity with a single member who manages operations; limited liability for the member; treated as disregarded entity (sole proprietorship or division) for tax purposes unless elect to be treated as corporation.

- b. Multi-member – a business entity with more than one member, all of whom manage operations; limited liability for all members; treated as a partnership for tax purposes unless elect to be treated as corporation.

- c. Manager-managed – same as single or multi-member except separate manager(s) manage operations.

5. Business Trust – trust organized under state law to carry on business with trustee and beneficiaries. Treated much like LLC for tax purposes.

## B. Income Tax Considerations

1. Tax rates: ordinary v. capital gains; rates on ordinary income range from 15% to 35% (plus state taxes); long-term capital gains generally taxed at 15%; dividends from corporations are subject to 15% tax rate.

2. Tax basis/determination of gain – tax basis of stock or partnership interest is generally equal to cost. For passthrough entities (Sub S corporations and partnerships), basis is adjusted to take account of income, losses and distributions. Gain (or loss) on a

sale or other disposition is generally determined by subtracting tax basis from sales proceeds. Type of gain (long-term capital gain, ordinary income) is determined by reference to holding period of asset sold and type of asset.

- a. Basis step up at death -- under current law, upon death, tax basis of asset is equal to fair market value at date of death (or subsequent election period). If estate tax is repealed, tax basis becomes a carryover of decedent's basis leaving open possibility of income tax on sale by decedent's heirs.
- b. Carryover/substituted basis -- various transactions require substitute or carryover tax basis to maintain potential for income taxation on subsequent sale. Gift property has carryover basis equal to donor's basis for gain purposes and fair market value basis for loss purposes.

### 3. Sales and Dispositions

- a. Taxable -- these transaction could result in taxable gain or loss
  - i. Asset sale -- sale of specifically identified assets; allows choice and avoidance of potential liabilities
  - ii. Equity interest sale -- sale of ownership interest in entity (e.g., stock, LLC membership interest, partnership interest); indirectly responsible for entity level obligations
  - iii. Installment sale -- sale in which one or more payments are deferred; should bear interest; gain recognition deferred until payments are received; loss is not deferred.
  - iv. ESOP -- sale of corporate stock to an employee stock ownership plan (ESOP) provides opportunity to use corporate contributions to qualifying retirement

plan to purchase stock; requires coverage of all eligible employees.

- v. Private annuity – sale of asset/interest for agreement to make specified payments over specified period or terminating at death. Similar to installment sale except payment obligations terminate on death.

b. Nontaxable – careful compliance with formal requirements produces nontaxable transaction

- i. Corporate Reorganizations (Merger) – defined corporate transactions allow substitution of stock in acquiring company for assets/stock in acquired company. Basis is substituted to maintain tax deferral.

- ii. Like-kind exchange – exchange of assets for other like-kind assets (e.g., automobile for automobile); does not apply to partnership interests, stock or other contractual relationships.

- iii. Partnership liquidations -- distributions of assets in liquidation of a partnership interest are not taxable.

C. Estate and Gift Tax Considerations – federal tax on transfers of property upon gift or death. Estate tax is repealed in 2010 for one year only but Congress is considering alternatives.

- 1. Tax rates – range from 18% on taxable estates of \$10,000 to 47% (reducing to 45% by 2007) on taxable estates over \$2.5 million; gift tax maximum rate is 35% on taxable gifts over \$500,000

- 2. Valuation Matters – fair market value of property is basis for determination of taxation. Determining fair market value is generally by appraisal. For entities, discounts are applied to take account of lack of marketability and minority ownership and premium is applied for control.

3. Spousal Exemption – unlimited exemption for outright gifts and bequests to spouses. Some opportunities to transfer property in trust for benefit of spouse and obtain exemption so long as property is ultimately included in estate of spouse at his/her death.
4. Unified Credit: estate v. gift – estate tax credit determined by unified credit amount which is currently \$1.5 million per person increasing to \$3.5 million in 2009; gift tax credit is \$1 million fixed.
5. Life Insurance – life insurance is includible in estate if incidents of ownership of policy remain with decedent. Possible to exclude from estate if held in irrevocable trust.
6. Trusts – various types of trusts have differing tax consequences. Irrevocable trust generally results in removal of assets from estate but concern for taxable gifts. Revocable trusts generally result in inclusion of assets in estate because of control. Different results could arise for income, gift and estate purposes by using complex arrangements.
7. Section 2057 Considerations – deduction of up to \$675,000 allowed for certain qualifying family-owned businesses; value of business (plus gifts of interests in the business) must exceed 50% of adjusted gross estate; must be family-owned and operated for 5 of last 8 years; elective provision with requirement for additional tax if interests disposed of within 10 years following death. Very complicated for relatively minimal benefit.
8. Section 6166 Considerations – payment of estate tax is deferred for value of interest in closely held business; interest only for 5 years with balance payable over following 10 years; acceleration of payment if disposition of interest or funds withdrawn constituting 50% or more of interest; also quite complicated.

#### D. Single Owner/Family Business

1. Structure Dependent – determine if single owner is proprietorship, single member LLC or sole shareholder corporation (regular or S)
2. Succession Considerations

- a. Ownership – who will own business and receive economic benefits
  - b. Control – who will control/run business and for what consideration
  - c. Business matters – concern about non-family employees; bank relationships; landlord consent; related topics
3. Mechanism – Will, trust, sale
  4. Techniques – Case Study Examples

E. Multi-owner/Family Business

1. Structure Dependent – determine if partnership, LLC or corporation (regular or S)
2. Succession Considerations
  - a. Ownership – who will own and receive economic benefits
  - b. Control – who will control/run business and for what consideration
  - c. Business matters -- concern about non-family employees; bank relationships; landlord consent; related topics
3. Mechanism – Will, trust, shareholder/partnership/LLC agreement, sale
4. Techniques – Case Study Examples

F. Multi-owner/Multi-family Business

1. Structure Dependent – determine if partnership, LLC or corporation (regular or S)
2. Succession Considerations
  - a. Ownership – who will own and receive economic benefits
  - b. Control – who will control/run business and for what consideration

- c. Business matters – concern about non-family employees; bank relationships; landlord consent; related topics
3. Mechanism – Will, trust, shareholder/partnership/LLC agreement, sale
4. Techniques – Case Study Examples

#### IV. QUESTION AND ANSWER TIME/ALTERNATIVE ACTIVITY

#### V. WRAP-UP/CONCLUSION

Think about the problems – it's never too early to plan — create your "Envelope"

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