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Planning For The Closely Held Business:

A Case Study Integrating Estate, Succession,
and Retirement Plan Concepts in Anticipation
of an Exit.

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Case Study Facts

- Mr. and Mrs. Entrepreneur own:
 - A Business
 - Marketable Securities and Real Estate
 - Retirement Accounts
- They have 3 children:
 - Emily
 - Ernest
 - Evan

Overview

- The Early Years: Basic Estate Planning and Choosing Business Entity
- The Middle Years: Designing Retirement Plan and Succession Planning
- The Golden Years: Planning an Exit Strategy and Updating Estate Plan

THE EARLY YEARS: BASIC EP AND CHOICE OF ENTITY

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CASE STUDY FACTS

- Mr. and Mrs. Entrepreneur - Age 35
- Net Worth Statement:
 - Business: \$1M
 - Marketable Securities: \$200k; Real Estate: \$300k equity
 - Retirement Plans: \$500k
- Emily (age 6)
- Ernest (age 4)
- Evan (age 2)

BASIC ESTATE PLANNING

- Powers of Attorney
- Last Wills and Testaments
- Revocable Trusts
 - Protect children
 - Creditor protection and divorce protection upon first death
 - Post SECURE Act updates
 - Privacy outside of probate

BASIC ESTATE PLANNING

- ILITs
 - Provide liquidity and compensate for lost income
 - Remove death benefit from taxable estate
- Holding Trust
- Titling of Assets and Beneficiary Designations
 - Probate Avoidance

CHOICE OF ENTITY CONSIDERATIONS

- Asset protection/limited liability
 - LLC/Corporate entities provide equivalent protection
- Personal tax planning
 - Income tax, employment tax, NIIT, QBI, QOZ
- Development of business
 - Attracting investors
 - Compensation alternatives for employees and service providers
- Complexity of structure
 - Tax return/planning complexity
 - Industry issues

CHOICE OF ENTITY OPTIONS

- Limited Liability Company
 - Single member (disregarded entity)
 - Multiple member (partnership, corporation, or S corporation for federal income tax purposes)
 - Default is partnership for tax purposes
 - Can file Form 8832 and elect “C” and/or “S” corporation status
 - Traps for LLC that elects “S” corporation status
- Corporation
 - Default treatment as “C” corporation
 - Can elect “S” status

CHOICE OF ENTITY OPTIONS

- Limited Liability Company – Single Member
 - Mrs. or Mr. Entrepreneur as sole owner.
 - Disregarded for income tax purposes – income/loss from business reported on Schedule C.
 - All earnings subject to SE tax
 - Flexibility in subsequent operations –
 - No tax on contributions/distributions of property
 - Admittance of new member creates default partnership
 - Structure can change easily without tax consequence

CHOICE OF ENTITY OPTIONS

- Limited Liability Company – Partnership
 - Income tax benefits/consequences pass-through
 - Ability to take losses in early years of operations
 - Partners treated as receiving guaranteed payments (salary) and income distributions, all of which are subject to SE tax.
 - Special allocations of income/loss permitted
 - Partners unable to participate in certain benefit arrangements.
 - No tax on contributions/distributions of property.
 - Structure can change easily without tax consequence
 - Flexibility for incentive compensation structure

CHOICE OF ENTITY OPTIONS

- Limited Liability Company – “S” Election
 - LLC may elect to be treated as S corporation. Deemed election to be treated as C corporation and subsequent S election.
 - Operating agreement should be drafted in compliance with single class of stock rule and override any partnership tax language
 - Both Mrs. and Mr. Entrepreneur can be owners and employees. If multiple owners, still must abide by S corporation restrictions (i.e., single class of stock and proportionate distributions and distribution rights).
 - Mr. and Mrs. Entrepreneur should draw ‘reasonable’ compensation for work performed.

CHOICE OF ENTITY OPTIONS

- “S” Election – Benefits & Consequences
 - Pass-through taxation/single layer of tax
 - No employment tax on dividend/profit distributions
 - No special allocations or preferred returns.
 - More than 2% owners unable to participate in certain employee benefit plan arrangements
 - Limited options on incentive equity grants for key-employees in future without more complex structuring
 - In-kind distributions trigger tax at corporate level, as does a conversion to partnership

CHOICE OF ENTITY OPTIONS

- “C” Corporation
 - Business is formed either as corporate entity or as LLC that elects to be taxed as corporation
 - Corporation pays tax at (currently) lower federal income tax rate
 - Ability to accumulate cash at lower tax rate
 - Owner/employees paid reasonable compensation
 - Corporation declares/pays dividends to the extent of free cash flow. Dividends subject to qualified dividend rate.
 - Owner/employees fully participate in benefit arrangements

CHOICE OF ENTITY OPTIONS

- “C” Corporation
 - Pros:
 - Potential for Section 1202 – Qualified Small Business Stock – treatment upon disposition
 - Flexibility for employee equity incentives
 - Corporation pays tax at (currently) lower federal income tax rate
 - Corporation declares/pays dividends to the extent of free cash flow. Dividends subject to qualified dividend rate.
 - Owner/employees fully participate in benefit arrangements
 - Potentially attractive for investors
 - Cons:
 - Double taxation and concerns about rate fluctuation
 - Complexity associated with capital infusions, property distributions, and corporate restructuring

CHOICE OF ENTITY OPTIONS

- Decision Points:
 - Some form of entity desired for limited liability
 - Early on, pass-through taxation is likely preferable either as SMLLC or partnership, without additional complexity of “S” corporation overlay.
 - Retain flexibility; less complicated
 - In early years, the employment tax benefits of “S” corporations likely don’t outweigh loss of flexibility
 - As business matures, consider tax rates then in effect and consider “S” election, or potentially “C” corporation status (potentially to preserve Section 1202 treatment)

THE MIDDLE YEARS: RETIREMENT PLAN DESIGN AND SUCCESSION PLANNING FOR MR. AND MRS. ENTREPRENEUR

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Case Study Facts

- Mr. and Mrs. Entrepreneur - Age 45
- Net Worth Statement:
 - Business: \$10M
 - Marketable Securities: \$300k, Real Estate: \$400k equity
 - Retirement Plans: \$750k
- Emily (age 16)
- Ernest (age 14)
- Evan (age 12)

Planning with Retirement Plans and Equity/Deferred Compensation Alternatives

A. Qualified Plans:

1. Defined Contribution (“DC”) Plans
2. Defined Benefit (“DB”) Plans

B. Deferred/Executive Compensation Alternatives:

1. Equity based:
 1. Incentive stock options
 2. Non-qualified stock options, restricted stock, SARs
 3. Profits-interests
2. Phantom equity plans (LTIP, UAR, EPP, etc.)
3. Change of control arrangements

Goals and Benefits for Retirement/Compensatory Plans

1. Qualified plans:

1. Provide vehicle to ALL employees to fund retirement and promote financial stability.
2. Employee retention/workforce stability.
3. Tax planning: income tax deferral for employees, current deductibility for employer of employer contributions.
4. Provide significant benefits to owners/highly compensated through deferral, deductibility, employee retention.

2. Non-qualified Plans:

1. Incentivize performance through employer contributions, equity grants, appreciation rights.
2. Retention for key-employees by aligning program with ownership
3. Potential for CG tax treatment on exit

The Entrepreneurs – DB Plan Example

1. Both are maximizing DC plan and are making 3%-4.5% contribution for employees (SH and PS)
2. DB Plan – if the Entrepreneurs are willing to contribute a total of ~7.5% of NHCE compensation (incremental 3%-4.5%), can shelter ~\$300k in DB plan annually.
3. All contributions deductible currently.
4. PS contributions subject to vesting schedule.
5. Can treat employee contributions as part of package of compensation.

Equity/Deferred Compensation Alternatives

- A. Many successful privately held businesses provide some sort of arrangement as tool to reward, incentivize, and retain key personnel.
- B. Plans can take many forms:
 - A. Cash-based – employee receives annual award or cash ‘credit’ or payment that is paid in future. Simple, but does not align employee with owners (i.e., isn’t based on appreciation).
 - B. Phantom-equity – many styles, but gives key-employees a sense of ownership and alignment with more significant upside, typically in event of change of control.
- C. Equity plans:
 - A. Can provide employee with more favorable tax treatment.
 - B. Common in entities classified as partnerships (profits interests, usually) because interests can be creatively designed and targeted.
 - C. Less common in “S” corporation entities due to more restrictive rules.
 - D. “C” corporations offer more alternatives/flexibility in equity plans than in “S” corporation.
 - E. Consider ramifications of granting co-ownership.
- C. Compliance with Section 83, 409A, etc., is required and can be significant issue in exit.
- D. Change in control provisions, and manner of payments, can provide comfort to acquirer in regard to retention of key employees post-closing.

Succession Planning – GRAT, Sale to Defective Trust, Spousal Trust

Succession Planning – Goals

- Business has started to grow and value has materially increased
- Desire to create a structure where future growth is outside the federal estate and gift tax system
- May require a recapitalization of equity in the business

Succession Planning – Recapitalization

- Recapitalize equity with 1% voting and 99% nonvoting
- For LLC – amend operating agreement
- For S corporation – amend articles to create voting and nonvoting stock
- After Recap: each of Mr. and Mrs. Entrepreneur own 0.5% voting and 49.5% nonvoting

Succession Planning – GRAT

- Irrevocable trust in which the grantor retains the right to a fixed annuity from the trust for a term of years.
- If the grantor survives the term, the trust principal passes to the beneficiaries or a trust for their benefit.
- Trust principal, including the appreciation on the principal, is excluded from the grantor's estate for federal estate tax purposes.

Succession Planning – GRAT Example

- Mr. Entrepreneur creates an 8 year GRAT and contributes his 49.5% nonvoting equity in business.
- 49.5% nonvoting interest in the business is valued at \$3,217,500 which reflects an aggregate 35% discount for lack of control and lack of marketability.

Succession Planning – GRAT Example

- Using the IRS 7520 Rate of 0.4% for November 2020, an annuity payment of \$408,622.50 would be required each year for eight years.
- If the business generated \$825,500 of distributions per year, the GRAT would be able to make the payments each year.

Succession Planning – GRAT Example

- GRAT terminates after 8 years and 49.5% nonvoting interest in the business passes to an irrevocable trust and is outside the estate.
- If value has not changed, then \$4,950,000 might have transferred without any material gift or estate tax consequence.

Succession Planning – Sale to Defective Trust

- Similar to a GRAT in structure
- Removes asset from the estate by utilizing the cash flow from the asset
- Requires a seed gift (at least 10%) to an irrevocable trust which is taxed as a “grantor” trust
- Sale of an asset to the “grantor” trust in exchange for a down payment and a promissory note

Sale to Defective Trust - Example

- Mr. Entrepreneur gives a seed gift of \$400,000 to a new irrevocable grantor trust
- Mr. Entrepreneur sells his 49.5% of nonvoting interests in the business to the grantor trust for \$3,217,500 (the appraised value)

Sale to Defective Trust - Example

- Trust pays a \$400,000 down payment and gives Mr. Entrepreneur a promissory note for \$2,817,500 with interest at 0.4% and matures in 9 years.
- Cash flow from business pays down note each year.
- If Business distributes \$825,000 per year, then trust will have \$408,375 to make payments on note.

GRAT v. Sale to Defective Trust

- Use of Exemption
- Flexibility with Payments
- Mortality Risk
- Valuation Risk
- Interest Rate/7520 Rate

Spousal GST Trust

- Variation of an irrevocable “grantor” trust
- Could involve a gift or sale transaction
- One spouse creates an irrevocable trust for the benefit of the other
- Beneficiary spouse could be the trustee of the irrevocable trust

Spousal GST Trust

- The value of the assets transferred into the Spousal GST Trust (and their growth) should escape the federal and state estate tax system permanently.
- The spouse may enjoy the assets as if they were never transferred.
- Future flexibility for distributing the assets upon the beneficiary spouse's death remains in place.

Spousal GST Trust - Example

- Mr. Entrepreneur creates an irrevocable trust for the benefit of Mrs. Entrepreneur.
- Mr. Entrepreneur transfers his 49.5% nonvoting interest in the business to the new spousal trust.
- Transfer could be by gift or sale.

Spousal GST Trust – All Gift

- Mr. Entrepreneur's gift of the 49.5% uses \$3,217,500 of his lifetime giving exemption
- All future growth and income from this interest is outside of the estate tax system

Spousal GST Trust – Sale

- Structured just like the sale to the defective trust.
- Mr. Entrepreneur gives a seed gift of \$400,000 to a new irrevocable grantor trust
- Mr. Entrepreneur sells his 49.5% of nonvoting interests in the business to the grantor trust for \$3,217,500 (the appraised value)
- Trust pays a \$400,000 down payment and gives Mr. Entrepreneur a promissory note for \$2,817,500 with interest at 0.4% and matures in 9 years.

Spousal GST Trust – Gift v. Sale

- In both structures the value of the transferred interest, income/distributions with respect to the interest and future increases in value are out of the estate tax system.
- Under sale the value of the promissory note is still part of Mr. Entrepreneur's estate.
- Gift uses more estate tax exemption than sale.

Spousal GST Trust – Gift v. Sale

- Treatment of distributions/note payments:
 - For sale: Payments on promissory note do not impact estate tax analysis
 - For gift: Distributions increase assets that are part of the estate tax analysis
- Spousal trust is a “grantor” trust with respect to Mr. Entrepreneur so need a plan for paying income taxes

Spousal GST Trust – Endgame

- Possible creation of a spousal trust by Mrs. Entrepreneur for Mr. Entrepreneur's benefit
 - Could gift or sell her 49.5% nonvoting interest to the second spousal trust
 - Be aware of the Reciprocal Trust Doctrine

Spousal GST Trust – Endgame

- A future sale of the business could result in material assets being held in each spousal trust:
 - Funds held in spousal trusts would be out of the estate tax system
 - Funds would be accessible to Mr. and Mrs. Entrepreneur as beneficiaries of the trusts
 - Mr. and Mrs. Entrepreneur can spend assets outside of the spousal trusts before using any assets inside the spousal trusts

THE GOLDEN YEARS: PLANNING AN EXIT STRATEGY

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Case Study Facts

- Mr. and Mrs. Entrepreneur - Age 55
- Net Worth Statement:
 - Business: \$40M
 - Marketable Securities: \$500K, Real Estate: \$750K equity
 - Retirement Plans: \$1.2M
- Emily (age 26) - inactive in the business but spouse, Eli, is active in the business
- Ernest (age 24) - inactive- owns a separate business
- Evan (age 22) - active in the business

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- Updates to Basic EP Documents
 - Name children in various roles, remove guardian
 - Charitable giving
- Basic EP Documents for children
- Pre-Nuptial Agreements
- Family values/wealth conversations with children
- DAF
- Charitable Lead Trust

What are your goals for an exit?

- Immediate liquidity event
- Transitioning the business to the next generation
- Stability for employees
- Retire or keep working

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What are your options?

- Internal succession plan
- Sale to a strategic buyer
- Sale to a financial buyer
- ESOP

Preparing for an Exit

- Tie up loose ends (tax audits, litigation, other disputes)
- Get your financial information in order
- Determine who is on your team
 - External advisors (may not be historic advisors)
 - Internal team members
- Consider third party requirements (key employees, suppliers and customers, landlords)

Finding a Buyer and Determining Value

- Contacting industry connections and advisors
- Hiring an investment banker
- There is usually not a readily determinable market value for closely held businesses
 - Investment bankers may have an estimate based on similar transactions
 - A competitive “auction” process can help establish the market value

The Sale Process

- If conducting a competitive process, usually starts with internal preparation and production of marketing materials (e.g., teaser, confidential information memorandum)
- Buyers submit letters of intent or indications of interest (non-binding, except for certain provisions)
- Due diligence conducted by selected buyer or buyers

The Sale Process (continued)

- Negotiation of transaction documents
 - Purchase Agreement
 - Lease
 - Employment Agreements
 - Equity Documents
- Closing!

Conclusions

- Take advantage of tax, retirement, and succession planning opportunities at each step of the life cycle of a business.
- Truly enjoy those golden years.



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