

TAX E-NEWS - BUSINESS SUCCESSION PLANNING

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SEPTEMBER 26, 2011

BUSINESS SUCCESSION PLANNING AND THE IMPORTANCE OF BUY-SELL ARRANGEMENTS

Have you recently had the opportunity to discuss with your clients that own closely-held businesses what the plan is if they or one of their partners left the business, either voluntarily or due to his or her death or disability? Without a proper business succession plan, the result could be devastating for your client or his or her partners and family left behind. An early and thorough discussion with the business owners is almost always the best option to discuss long term goals, structure and tax consequences to the individual, to his or her family and to the business. In many cases, the parties will agree that a buy-sell agreement is the best solution.

Typically, a buy-sell agreement (or similar provisions in a limited liability company operating agreement) obligates the remaining owners and/or the business itself to purchase the ownership interests (or are given an option to purchase) if certain "triggering events" take place. A buy-sell agreement between the business owners is typically referred to as a "cross-purchase agreement" and a buy sell agreement by and between the owners and the business entity, is commonly referred to as a "redemption agreement" or "entity purchase agreement". In both cases, the common triggering events include death, disability, retirement, termination of employment and bankruptcy. A buy-sell agreement will also generally set the value or a method for determining the value of the ownership interests and whether so-called minority and lack of transferability principles should be taken into account as part of the valuation process. It should also include the terms of the payment and may include other restrictions on the transfer of the equity interests and provide a funding source for the purchase of the ownership interests (i.e., insurance).

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A succession plan and the buy-sell agreement to implement the plan should be structured to take into consideration the possible income tax, gift tax and estate tax consequences associated with the transfer of ownership interests. The tax consequences are largely dependent on the type of business organization, i.e. corporation, limited liability company (or partnership), and the type of buy-sell agreement established by the owners, i.e. cross-purchase agreement or redemption agreement. The following presents certain tax issues and possible planning opportunities for businesses taxed as corporations or partnerships.

Corporations:

Under Section 317(b) of the Internal Revenue Code of 1986, as amended (the “Code”), a “redemption of stock” is a corporation’s acquisition of “its stock from a shareholder in exchange for cash, debt securities or other property (not including stock and stock rights in the redeeming corporation), whether or not the stock so acquired is cancelled, retired, or held as treasury stock.” Section 302 governs the taxation of a distribution in redemption of corporate stock. If the distribution meets the requirements of Section 302(b), then the shareholder is entitled to treat the transaction as a sale or exchange of the redeemed stock (i.e., a sale transaction) as described in Section 302(a), rather than a dividend governed by Section 301. For the transaction to be treated as a sale or exchange transaction pursuant to Section 302, the redemption must satisfy any one (1) of the four (4) tests set forth in section 302(b). It is important to note, the constructive ownership rules of Section 318 apply to determining the ownership of stock for the purposes of some, but not all, of the Section 302(b) tests.

The difference in the tax results between sale or exchange treatment and dividend treatment could be dramatic for the selling shareholder. The tax treatment of a sale/exchange allows the shareholder to reduce the amount distributed by the shareholder’s adjusted basis. The net amount distributed also results in capital gain or loss to the shareholder, which may be an advantage over dividend treatment if a dividend would have been taxed as ordinary income. If the distribution is treated as a dividend (i.e., it does not meet the Section 302(b) tests), then the shareholder may not use his or her adjusted basis to reduce the amount of the dividend and higher tax rates may apply (if not treated as “qualified dividend income”). Given that “qualified dividend income” is currently taxable as net capital gain rather than ordinary income there may not be much of a difference between the sale or exchange verse dividend treatment (at least from an effective tax rate perspective), but it is important to note that the reduced taxation of qualified dividend income is subject to a sunset clause ending the reduced rate for taxable years beginning after December 31, 2012.

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Redemption payments (at least principal amounts) are non-deductible to the corporation. See Section 162(k) of the Code. A redemption of a shareholder's shares has no effect on the corporation's basis in its assets. In the case of appreciated property being distributed as part of a nonliquidating redemption, the distributing corporation recognizes gain on a distribution of appreciated property, but may not recognize loss on a distribution of property that has declined in value. Section 311(a-b).

The tax consequences of a cross-purchase by the remaining shareholder(s) to the selling shareholder are generally determined under Section 1001 of the Code, and the selling shareholder generally has gain or loss (capital if the shareholder held his or her shares as a capital asset, and long-term if held for 1yr or more) equal to any excess of the amount he or she realizes in the sale over his or her basis. The cross-purchase has no effect on the corporation or its basis in its assets. The purchasing shareholders may not deduct the amounts they pay for the purchased shares, but they take basis in the shares they purchase equal to the amounts they pay for the shares (and therefore get overall basis increases in their shares of the corporation). There may be issues regarding funding of the cross-purchase if the purchasing shareholders have paid with amounts received from the corporation as compensation or dividends, they've had to recognize income to get their basis increases. If they paid with dividends, then the amounts paid were taxable both to the corporation and to the shareholder. Thus, if the corporation is the source of the amounts paid to the departing shareholder, then it may be more tax efficient to have the corporation purchase the shares as a redemption, at least if the corporation is a C corporation (subject to double tax).

There is an exception in the Interest & Dividend Tax ("I&D") (RSA 77:4-c) that excludes from the I&D the amount received from sales, exchanges or transfers of transferable shares whether by way of liquidation, redemption or otherwise and irrespective of the parties to the sale, exchange or transfer. The transferable shares can be corporate stock or other ownership interests that are transferable including partnership and limited liability company member interests.

Partnerships:

The redemption of a partner's interest will be treated as a liquidation. A "liquidation" is the termination of a partner's entire interest in a partnership by means of a distribution or series of distributions to the partner by the partnership. The partner whose interest is being liquidated is referred to as the "retiring partner." For this transaction, Section 736 of the Code is the starting point for determining the tax consequences of payments in liquidation of a

partner's interest in a partnership. Section 736 is directed to the analysis to the sections that apply and applies only to payments made to a retiring partner or to a deceased partner's successor in interest. Reg. Section 1.736-1(a)(1)(i). The tax consequences of the cross-purchase to the selling partner are determined under Sections 751(a) and 741 of the Code. The amount paid to the selling partner is deemed to include his share of the partnership's debt.

A retiring partner can structure his departure from the partnership as either a liquidation of the interest under Section 736 or as a sale of the interest to the continuing partners. The critical difference is that Section 736(a) liquidating distributions generally produce ordinary income to the retiring partner and reduce the income reportable by the continuing partners, while a sale of an interest to the continuing partners produces capital gain to the retiring partner, except as provided in Section 751(a), and the continuing partners must capitalize the purchase price as part of their outside bases (continuing partners may make a Section 754 election to "step up" basis – but should consider the Business Profits Tax implications of such an election)

Conclusion

The primary purpose of a buy-sell agreement is to protect not only the interests of the owners who are exiting the business (or their estates), but also the interests of the owners who remain. Without a buy-sell agreement, the parties will not have agreed to a structure or method to implement the transaction or to value the departing owner's interest. In the event of a death, the business and its remaining owners may not have sufficient funds to pay fair market value to the deceased owner's estate for its ownership interests and the family of the deceased owner may realize very little from the business that the deceased owner worked hard to build. These matters and other potential pitfalls can be avoided or minimized with a thoughtfully implemented plan.

A well-crafted buy-sell agreement can address not only the issues surrounding the death of an owner, but also resolve similar issues in situations in which one of the business owners withdraws from the business, either voluntarily or involuntarily. These provisions can be drafted to align partners' interests and disincentive partnership withdrawal. They also can reduce the likelihood or avoid altogether the possibility of protracted and expensive litigation. In either the situation of a deceased owner or a withdrawing owner, the chances of litigation are high if there is no buy-sell agreement in place and the parties are unable to negotiate satisfactory terms for the transfer of the ownership interests.

Section 736 directs the analysis to the sections of the Code which apply only to payments made to a retiring partner or to a deceased partner's successor in interest. Although the establishment of such a plan may seem complicated, it typically only requires the owners with assistance from their advisors to make a few important choices. In contrast, a closely-held business that does not have a buy-sell agreement often faces significant problems that are difficult to resolve at a critical time for the business and the remaining parties.

The members of Devine Millimet's Business Planning Practice Group assist clients with a wide range of business, tax and financial matters. We assist first-time and seasoned entrepreneurs, small and large privately held businesses and family owned enterprises, with all issues that relate to their businesses, including: entity formation; contract preparation, review and negotiation; raising of capital or debt; and governance, business finance, and succession planning. From first-time entrepreneurs to experienced business leaders, we work with clients and their advisors to identify risks that can affect their business, form strategies to alleviate those risks and implement tactics to accomplish the clients' goals.

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