# Business Succession Planning with LLCs

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ESTABLISHED 1871



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# Topics to be Covered

Overview of Key Differences between Corporations and LLCs

- Formation
- Taxation
- Equity Incentives to Employees
- Self-Employment Tax

Succession Planning with LLCs



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# Formation of Corporations

Formed by filing Articles of Incorporation or a Certificate of Incorporation with a State's Secretary of State.

A corporation is a separate legal entity with liability generally limited to the assets of the Corporation.

State corporation laws have major impact on the relationship among shareholders along with Bylaws and Shareholder Agreements



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# Formation of Corporations

Stock is issued to shareholders in exchange for a contribution of capital (cash or property)

Stock cannot generally be issued for future services without tax consequences for the receiving shareholder (more about this later)



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# Formation of LLCs

Formed by filing Articles of Organization or a Certificate of Formation with a State’s Secretary of State.

An LLC is a separate legal entity with liability generally limited to the assets of the LLC.

LLCs have members instead of shareholders



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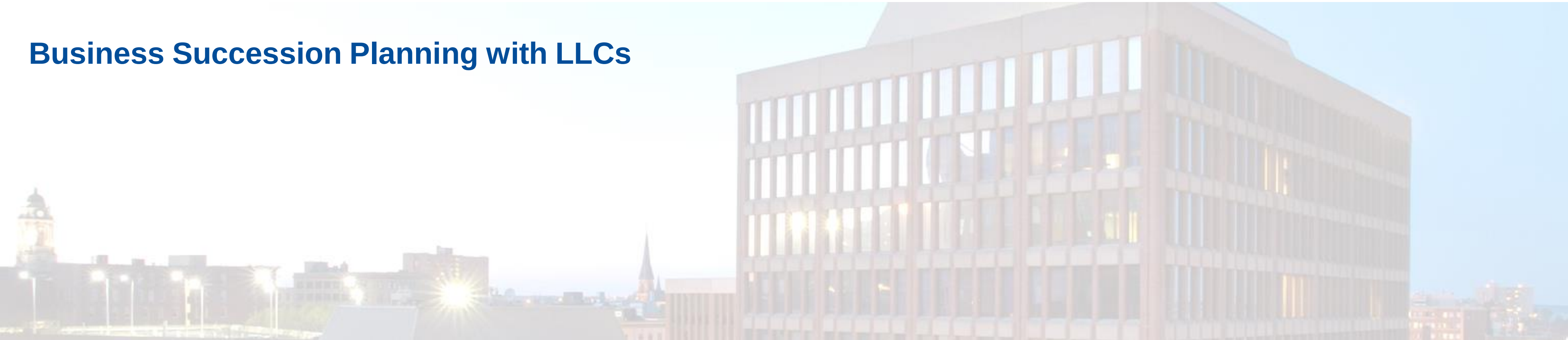

# Formation of LLCs

LLC Operating Agreement governs the relationship of the members

State LLC Acts generally defer to the LLC Operating Agreement with exception of each member’s duty of good faith and fair dealing

Great flexibility in drafting LLC Agreement



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# Taxation of Corporations

"C" Corporation - a corporation that has not made an S election with the IRS

Double taxation: C Corporation pays tax on its income and shareholders pay additional tax on distributions received from the corporation

Taxable distributions are usually dividends or capital gains



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# Taxation of Corporations

"S" Corporation - a corporation that has made an S election with the IRS

S Corporation are not taxable entities; income, deductions and credits pass-through to shareholders

Exception: "built-in gains" or "BIG Tax - a C corporation with appreciated assets makes an S election – applies for  5 years



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# Taxation of Corporations

S Corporations subject strict rules

- no more than 100 shareholders

- only individuals, estates and certain trusts can be shareholders (NOTE: a multi-member LLC cannot be a shareholder of an S corporation)

- a non-resident alien cannot be a shareholder

- a stockholder’s initial tax basis in stock is limited to capital contribution; share of corporation’s debt is not included in tax basis



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# Taxation of Corporations

## S Corporations subject strict rules (Continued)

<u>Only one class of stock allowed</u>

- Voting and Non-Voting Stock allowed

- Stock must confer <u>identical</u> rights to distributions and liquidation proceeds ("pro-rata distributions")

- Disproportionate distributions as to timing and amount are generally allowed subject to a subsequent true-up (but be careful)



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# Taxation of Corporations

Distribution by corporation of appreciated assets to a shareholder (in liquidation or otherwise) is treated as a taxable sale by the corporation which passes through to shareholder

Applies to C and S corporations

Applies to entity conversions – C or S corporation conversion to an LLC is treated as a taxable sale



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# Taxation of Corporations

One advantage of corporations compared to other entities is a well developed law of non-taxable reorganizations

Three general types of reorganization:

- Single Entity Reorganizations
- Acquisitive Reorganizations
- Divisive Reorganizations

We will focus on Single Entity Reorganization



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# Taxation of Corporations

"F" Reorganization under IRC Section 368(a)(1)

"a mere change in identity, form, or place of organization of one corporation, however effected;"

Includes a statutory merger used to change a corporation's State of domicile

Statute is vague but 2015 IRS regulations elaborated on what constitutes a "mere change"



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# Taxation of LLCs

LLCs are not taxable entities - income, deductions and credits pass-through to members

Single member LLC is a "disregarded entity" and member reports tax items on member's tax return

Multi-member LLC is a partnership and partners report their share of tax items

LLC can elect to be taxed as a corporation



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# Taxation of LLCs

Member's share of LLC debt is included in Member's tax basis

Unlike a corporation, distributions to LLC members are generally non-taxable

Members take a "carry-over" basis in the assets

Exceptions: distributions treated as disguised sales and certain allocations of pre-contribution built-in gain



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# Equity to Employees - Corporations

Shares of Corporation issued to employees who do not pay for the shares are generally treated as W-2 compensation

Taxed at ordinary income rates, not capital gains rates

No “gifts” of stock are allowed for employees



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# Equity to Employees - Corporations

Stock to employees generally take the form of awards of Restricted Stock and/or Stock Options

Phantom stock and Stock Appreciation Rights (SARs) are not actual stock but are an award calculated to replicate stock ownership

“Section 83(b) Election” can be made by employee to allow future stock appreciation to be taxed as capital gain



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# Equity to Employees - LLCs

In a LLC taxed as a partnership, an individual cannot be both a partner and an employee

Income to employees reported on form W-2

Income to partners is reported on Schedule K-1 of LLC's tax return (Form 1065)

Certain fringe benefits available to employees but not partners (e.g., cafeteria plans, tax-free life insurance)



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# Equity to Employees - LLCs

"Capital Interests" and "Profits Interests" in a LLC taxed as a partnership

<u>Capital Interest</u> is an interest that would provide a partner with a share of proceeds if LLC assets were sold at FMV in a hypothetical sale

<u>Profits Interest</u> provides a share of future profits but no interest in LLC assets on date the profits interest is created.



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# Self-Employment Tax - LLCs

Purpose of SE Tax is to collect the equivalent of FICA taxes from self-employed persons

Federal Insurance Contributions Act (FICA)

7.65% from Employers

7.65% from Employees

FICA applies to Taxable Wage Base

$142,800 for 2021

Self-employed person pays 15.30% SE Tax



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# Self-Employment Tax - LLCs

SE Tax applies to “net earnings from self-employment” which is net income from a trade or business carried on by a sole proprietor or partner in a partnership whether or not the income is distributed

Exclusions from SE Tax: rental income; interest and dividends; capital gains or losses; distributive share of a limited partner



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# Self-Employment Tax - LLCs

Key Distinction – income from labor versus income from capital

Is a partner like an employee (SE Tax applies)

Is a partner like an investor (SE Tax does not apply)



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# Self-Employment Tax - LLCs

Advantage of S Corporations for SE Tax

S corporations can set low wages for its shareholders (subject to FICA) with remaining profits distributed as dividends (not subject to FICA)

IRS challenging low wages as unreasonable compensation and recharacterizing dividends as wages



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# Succession Planning

Many businesses are organized as S corporations

Can have real estate and operations in S corporation

Can have real estate owned by individual or LLC and have operations in S corporation



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# Succession Planning

Lack of flexibility of S corporations can impede succession planning

- Taxable distributions of appreciated assets

- Inability to convert to another entity form without risk of taxation

- Difficultly with equity incentives for employees



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# Succession Planning

It is also difficult for an owner to retain an investment in corporation after a sale without tax consequences

Third party buyers usually want to buy equity instead of business assets but also want a step up in basis for assets of the corporation

Buyers prefer a 338(h)(10) election that allows a stock sale to be taxed as an asset sale (but this has substantial tax consequences for the seller)

# Succession Planning with LLCs

Using an F Reorganization to transfer corporation assets to a newly formed LLC

Allows sale of LLC interest instead of S corporation stock

Facilitates investment from 3rd parties

Allows shareholders to sell less than all of the business (i.e., retain an investment)

Facilitates equity transfers to employees



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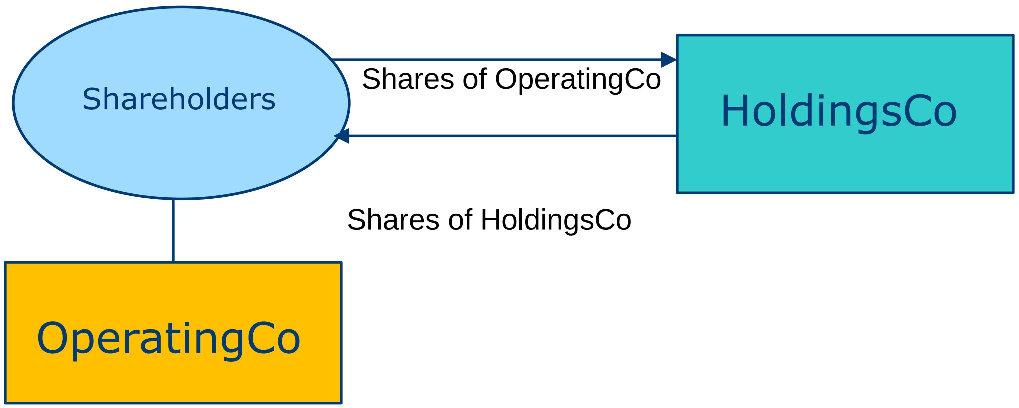
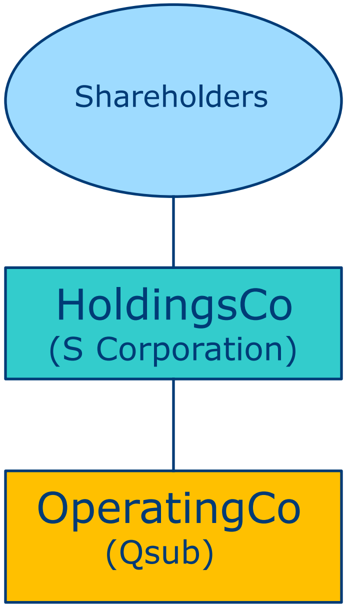
# Step 1
# Formation of Holding Company

Shareholders of OperatingCo transfer their shares to FarmHoldings for shares of FarmHoldings



# Ownership Structure after Step 1

## <u>Step 1</u>
## Formation of Holding Company




Shareholders are still shareholders of an S corporation

HoldingsCo retains its S Election but must get new EIN

OperatingCo is a "disregarded entity"

OperatingCo retains its historic EIN after making an election to be an "qualified subchapter S corporation" (Qsub)



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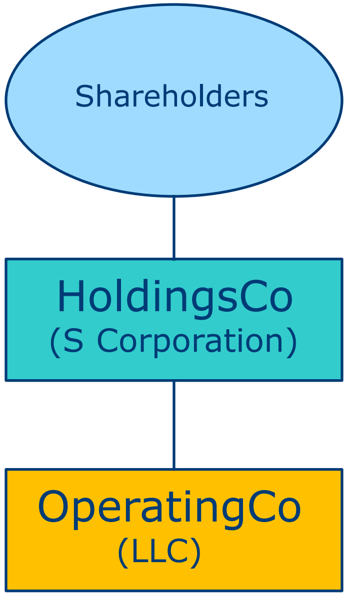
# Ownership Structure after Step 2

## Step 2
## Conversion of Qsub into LLC

Relevant IRS Rulings

Rev. Proc. 2008-18

PLR 201724013

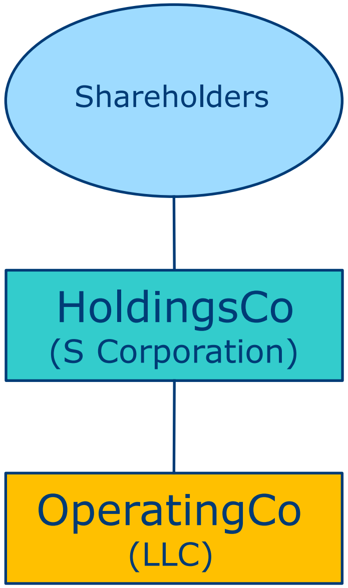



Shareholders are still shareholders in an S corporation

OperatingCo uses state law conversion statute to effect change to LLC (also a disregarded entity)

# Shareholder Redemption or Sale of Stock

## Planning Opportunities with new ownership structure




Prior to any sale transaction involving an employee or 3rd party, Corporation can redeem some or all of a Shareholder's stock or Shareholders can buy and sell among themselves

This pre-sale planning can mitigate the effect of the requirement for pro-rata distributions in a later sale



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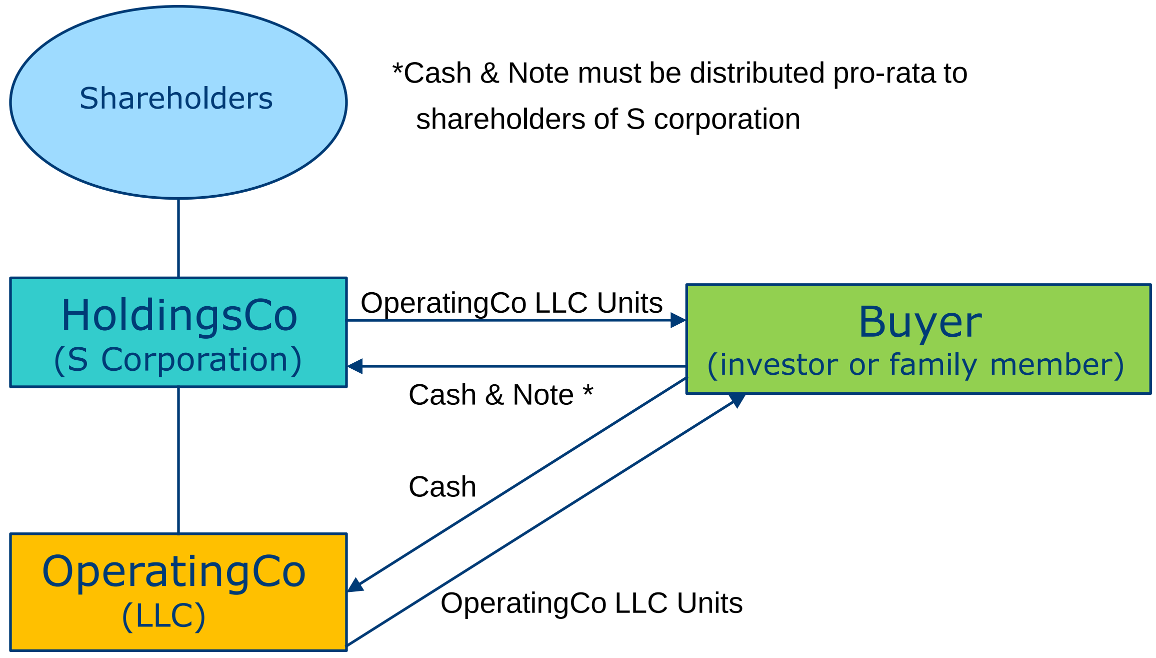
# Planning Opportunities with new ownership structure

## Sale of Stock and/or Sale of LLC interests




OperatingCo becomes a partnership



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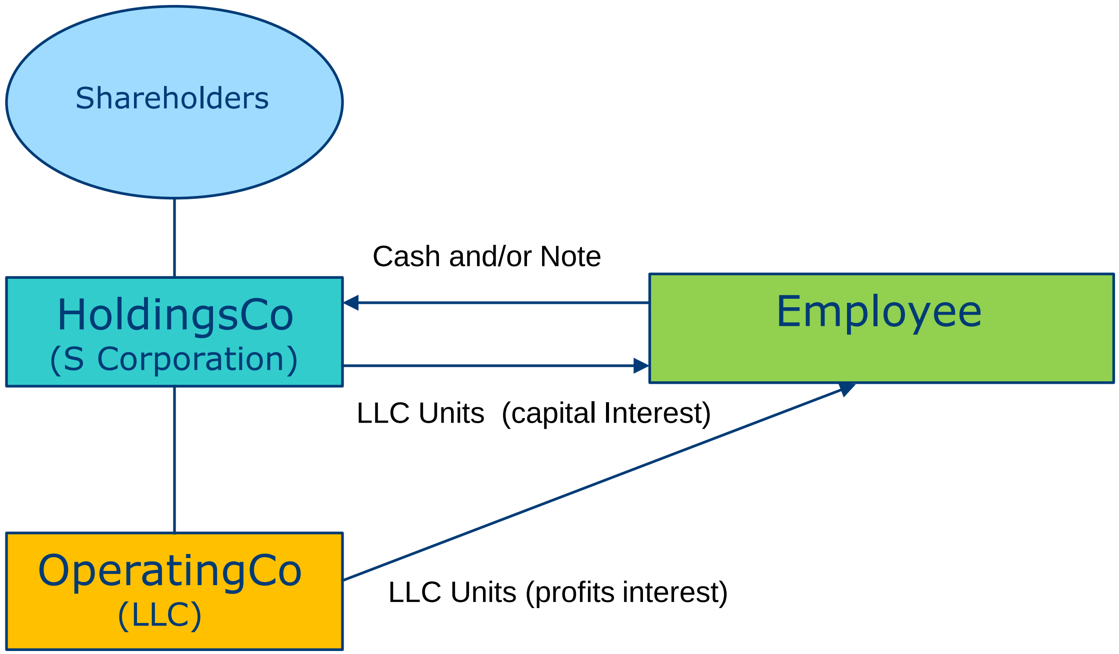
# Planning Opportunities with new ownership structure

## Transactions with Employees




OperatingCo becomes a partnership



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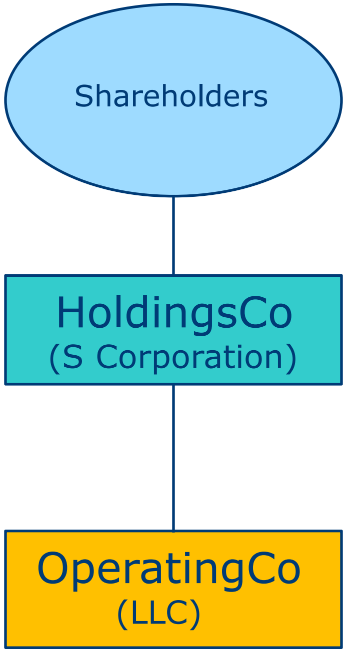
# Planning Opportunities with new ownership structure




<u>Remember</u>: shareholders still own stock in an S corporation so sales or distributions of appreciated OperatingCo assets will be taxable

F Reorganization facilitates new investments in OperatingCo without investors becoming shareholders of S corporation

Every planning situation is unique and should be analyzed by experienced tax professionals, ideally the accountant and attorney work closely



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