TAX AND ESTATE PLANNING FOR BUSINESS OWNERS

Ivan & Daugustinis
ESTATE AND TAX ATTORNEYS

I. ENTITY SELECTION & OWNERSHIP STRUCTURE

Choosing the ideal business entity is an important first step for business owners in Florida. Entity selection has a significant impact on asset protection, taxes, future expansion, and organizational flexibility. A few of the options include a sole proprietorship, general or limited partnership, limited liability company (LLC), or corporation.

- **Sole Proprietorship** – one owner, no state or federal filing requirements, unlimited personal liability, owner taxed directly
- **General Partnership** – multiple owners, no state or federal filing requirements (other than a federal tax return), unlimited personal liability, owners report income on individual return based on percentage ownership
- **Limited Partnership** – made up by general partners and limited partners, Florida business filings required, limited partners only liable up to amount invested, owners report income on individual return based on percentage ownership
- **Limited Liability Company (LLC)** – Florida business filings required, owners can elect to be taxed as a sole proprietorship or corporation (if a single member LLC) or a partnership or corporation (if multi-member LLC), significant asset protection if multi-member LLC
- **C-Corporation** – Florida business filings required, significant asset protection, can be subject to double taxation as corporation and shareholder
- **S-Corporation** - Florida business filings required, significant asset protection, no tax at corporate level, taxes passed through to shareholders

II. FEDERAL ESTATE TAX

The federal government imposes an estate tax on transfers at death based on the fair market value of assets owned by the transferor at the time of death. <u>The property subject to taxation at death includes business interests</u> and other personal assets such as real estate, cash, securities, life insurance, individual retirement accounts, pensions, and profit-sharing plans. For tax year 2022, any amounts over $12,060,000 are subject to federal estate tax. The tax due is 40% of all assets over the exemption.

Estate Tax Example: John Doe owns business and personal assets worth $25M at the time of his death. The first $12M can be transferred to heirs free of estate tax – however, the remaining $13M will be subject to federal estate tax. At a rate of 40%, John Doe's estate will owe over $5M to the IRS in federal estate tax.

III. PROTECTING BUSINESS AND PERSONAL ASSETS

Single-Member LLC vs. Multi-Member LLC. Florida law generally protects the assets of an LLC from the LLC owner's creditors by limiting creditors to obtaining a "charging order" against the owner's interest in the LLC. A charging order is a weak creditor remedy, as it only allows a creditor to collect against the owner's share of LLC distributions if and when such distributions are made. A charging order does not allow the creditor to force distributions from the LLC, force the owner to sell his or her LLC interest, or obtain ownership of the LLC interest. A creditor of the owner of a single-member LLC, however, is not limited to a charging order under Florida law and may foreclose against the LLC and ultimately obtain LLC assets.

Florida Statutory Exemptions. The Florida Statutes provide that certain assets are exempt from creditor claims. Exempt assets include head of household wages, annuities and life insurance proceeds, retirement accounts, homestead residence, disability income, and social security income.

Asset Protection for Married Couples. Florida allows married couples to hold assets jointly via tenancy by the entirety (TBE). With few exceptions, property held as TBE cannot be garnished or attached by one spouse's individual creditors. However, there are strict requirements that must be met to create joint ownership as TBE, so married couples should be sure to verify that their jointly held assets qualify as TBE.

IV. BUSINESS SUCCESSION PLANNING

As a business owner, it is important to ask yourself: "If I could no longer operate my business, what would happen to it?" If you struggle to answer this question, it is time to implement a business succession plan. For many small business owners, the equity in their business and the income it generates comprise the bulk of the owner's estate and provide the means of support for the business owner's family. Upon the death or disability of the owner, many families are left scrambling to operate a business they are unfamiliar with or unqualified to run, leading to the eventual loss of customers and key employees. Ultimately, the owner's family may be stuck with a business that loses its value or actually becomes a financial burden to the family. Fortunately, proper business succession planning can prevent this and provide an avenue to support the owner's heirs, whether through internal or external sale, continued operation by the family, or liquidation.

a. BUY-SELL AGREEMENT

A Buy-Sell agreement is an agreement among closely held business owners (which may be part of a shareholders' or operating agreement) that restricts the owners' rights to transfer their interests in the business. Buy-Sell Agreements give the business and/or owners the right (and sometimes the obligation) to purchase the interests of an owner when the owner dies or wishes to make a lifetime transfer of his or her interest in the business. In the case of death, this prevents the interest of a deceased owner from passing to others whom the remaining owners would not want to be in business with (e.g., a spouse) while simultaneously providing funds to the deceased owner's family from the sale of the deceased owner's interest.

- **Funding a Buy-Sell Agreement**. In some cases, a business or its owners may have sufficient funds to purchase a deceased owner's interest in the company. Generally, however, it works best to fund the purchase with life insurance using a redemption, cross-purchase, or alternative structure. Business owners should consult a business valuation expert (such as a CPA) to assess the value of their business to determine the level of insurance coverage needed and an insurance professional who can arrange funding of the buy-sell agreement and periodically review the plan.

- **Redemption**. With a redemption, the company pays life insurance premiums, is the beneficiary of the policy proceeds, and uses the proceeds to acquire a deceased owner's interest in the business. A redemption structure is simple to administer because the business owns and manages the policies; however, because the business receives the insurance proceeds on the death of an owner, the remaining owners will generally not receive a step up in basis on the redeemed interest.

- **Cross Purchase**. With a cross-purchase, the business owners individually own policies insuring each other's lives and use the policy proceeds to purchase the interest of a deceased owner. Any interest the surviving owners buy from the deceased owner will have a basis equal to the purchase price for the interest, reducing their future income tax liability if the company is later sold. However, there are disadvantages to a cross-purchase, such as the number of policies required if there are more than 2 owners (e.g., 3 owners requires six policies), the complexity of administration, and the potential tax resulting from the transfer-for-value rules if surviving owners acquire policies held by a deceased owner that later payout on the death of an owner. An alternative to a cross-purchase arrangement that eliminates some of the aforementioned disadvantages is forming an "Insurance LLC" to own and manage the insurance policies. When an owner of the operating business dies, the LLC collects the proceeds and distributes them to the surviving owners who then acquire the deceased owner's interest in the operating business.

b. RETENTION OF KEY EMPLOYEES

Many business owners desire that their business continue should something happen to them. Unless the business is operated entirely by family, it is often necessary to retain key employees to ensure its continued success. There are many ways to incentivize key employees to remain with the business and have an interest in its long-term success, including phantom stock plans, profits interests, and key-man insurance.

i. PHANTOM STOCK PLANS

A phantom stock plan is an employee benefit plan that can help retain key employees by giving them a financial incentive to help grow the company. As the name implies, this type of plan involves giving select employees "phantom" or "mock" shares of company stock. Key employees can enjoy the benefits of stock ownership and be motivated to see the company prosper - all without diluting shareholder equity.

ii. PROFITS INTEREST

LLCs have the ability to grant equity to key employees in the form of "Profits Interests," allowing these employees to share in future profits and appreciation of the LLC without triggering immediate income taxation. Generally, awarding equity to an employee in any entity, regardless of whether the entity is taxed as a C corporation, S corporation or tax partnership, requires the employee to recognize income equal to the value of the equity interest received (known as "phantom income"). However, if a profits interests meets certain requirements, it is not taxable to the recipient upon grant. Following the grant of a profits interest, the profits interest member shares in LLC income and appreciation to the extent the LLC appreciates in value from the time of the grant. The profits interest member will receive long-term capital gains treatment upon the sale of his or her profits interest, which is most likely to occur when the LLC sells. Although the profits interest doesn't give the member voting rights, he or she becomes a member for other purposes and must report salary paid from the LLC as self-employment income subject to employment taxes, and becomes entitled to information, including the right to review LLC books and records. However, because the profit interest does not require recognition of income upon receipt and does not have an acquisition cost (unlike a stock option), it is an attractive employee incentive to consider.

iii. KEY MAN INSURANCE

Key man insurance is an insurance policy purchased by a company on the life of an owner, a top executive, or another individual considered critical to the business. The company is the beneficiary of the policy and pays the premiums. The money from the policy can be used in a number of ways – to hire and train a new employee to take over the key person's role, to help wind up the business following the key man's death, distribute money to investors, etc. Key man insurance can also be used to insure against disability, but in general, it does not cover the loss of a key person who simply decides to retire or leave the business voluntarily.

c. SALE OF BUSINESS

In general, a business can be acquired in one of two ways – a stock (or equity) sale or an asset sale. It is important to determine which transaction structure is the most beneficial to you and your business.

i. STOCK OR EQUITY SALE

In a stock or equity sale, a buyer purchases shares of stock from a business' shareholders (or membership interests in the case of an LLC). The buyer gets equity in the business and assumes all assets and sometimes the liabilities (see Assumption of Liabilities below), since the entity continues as the operating business. Key considerations include:

- **Reduced Business Interruption**. In general, the buyer in a stock or equity sale can continue to do business with the same customers and vendors. Business licenses remain in place, and the buyer will not be forced to re-hire employees. Prior contracts and leases also may continue uninterrupted and allow for a smooth transition.

- **Assumption of Liabilities**. A stock or equity sale buyer is at risk for all the liabilities of the corporation, though this can be negotiated. It may be advisable for a stock or equity sale buyer to require payment of existing liabilities and/or enter into an indemnification agreement or hold harmless agreement where the seller remains liable for any liabilities that are not disclosed to the buyer before the sale.

- **Loss of Depreciation**. A stock sale purchaser inherits all assets of a corporation at the seller's depreciable base – this means the buyer does not receive a step up in basis on assets purchased. This can result in higher future taxes, as the buyer will not be able to depreciate assets based on a stepped up cost basis. However, in the case of a stock sale involving an S Corporation or an equity interest purchase of an LLC, there are special rules that allow for the buyer to obtain a step up in basis on the assets held in the entity (for example, see discussion of Section 338(h)(10) below).

ii. ASSET SALE

In an asset sale, the seller remains the owner of the legal entity and the buyer purchases the individual assets of the company, including equipment, fixtures, real estate, etc. This type of business sale is usually preferred by buyers. Key considerations include:

- **Stepped-Up Basis**. As opposed to a stock or equity sale, the buyer in an asset sale receives a step up in basis on the assets purchased. By allocating a higher value for assets that depreciate quickly (like equipment, vehicles) and by allocating lower values on assets that amortize slowly (like goodwill, which has a 15-year life), the buyer can gain additional tax benefits from the step up in basis.

- **No Established Credit**. Business interruption is likely in an asset sale. As the seller retains ownership of the legal entity, the buyer in an asset sale cannot simply take over previous contract relationships and will have to enter new agreements concerning vendors, customers, and employees. New business licenses will also have to be obtained.

- **Fresh Start**. The purchaser in an asset sale has a clean slate and generally will not be responsible for any of the seller's liabilities. Any negative credit history associated with the seller's business entity will also not transfer with the sale, allowing the buyer to establish their own creditworthiness.

V. BUSINESS SALE TAX CONSIDERATIONS

When you sell your business, you may face a significant tax bill. With skillful tax planning, it may be possible to minimize or defer some of your tax liability. The amount of tax that you will ultimately have to pay depends on a number of factors.

a. CAPITAL GAINS vs. ORDINARY INCOME

When selling a business, it is important to understand if the monies received will be treated as a capital gain or ordinary income for tax purposes. In general, taxes owed on capital gains are much lower than taxes owed on ordinary income (top individual capital gains tax rate for tax year 2022 is 20% compared to 37% for ordinary income). A seller will typically want to allocate as much of the purchase price to the capital assets that were transferred with the business, as proceeds from the sale of a capital asset are taxed at the lower capital gains rate. Certain assets may not be eligible for capital gains treatment, however.

b. SECTION 338 ELECTION

Section 338 of the tax code can provide significant tax relief to a purchaser of 80% or more of a corporation. Section 338(h)(10) election allows a buyer of stock of an S corporation (or other entity taxed as a S corporation) or a corporation within a consolidated group to treat the transaction as an acquisition of 100% of the assets of the corporation for tax purposes. As noted above, an asset sale is generally preferred by purchasers because it provides a stepped up tax basis and can significantly reduce future taxable income for the buyer.

c. QUALIFIED SMALL BUSINESS STOCK

If a business sale involves Qualified Small Business Stock (QSBS), some associated capital gains may be exempt from taxation. QSBS only applies to certain corporations – specifically, a C corporation created on or after August 9, 1993 that has had less than $50M in gross assets at all times since formation. In addition, some businesses are excluded based on the service or product it provides. A business is disqualified from QSBS if it uses more than 20% of its assets in the active conduct of business in the following areas:

- the performance of services in health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics or financial/brokerage services;
- banking, insurance, financing, leasing or similar businesses;
- farming;
- production or extraction of oil, gas or other natural deposits;
- hotels, motels, restaurants or similar businesses; and,
- any business where the principal asset is the reputation or skill of one or more employees.

If a business qualifies for QSBS, shareholders can exclude a significant portion of associated capital gains when selling or exchanging that stock, if shares are held for over five years. Depending on the circumstances, a business sale involving QSBS can allow a seller to exclude anywhere between 50-100% of the capital gains from taxation.

d. DEPRECIATION RECAPTURE

As noted above, an asset sale may allow a buyer to depreciate some assets for tax purposes. However, if the asset is sold at some point down the road, it may be subject to depreciation recapture by the IRS. Tax is assessed when the sale price of an asset exceeds the tax basis or adjusted cost basis of the asset in question. As an example, let's say a business owns a $50,000 vehicle with a 10-year lifespan and salvage value of $10,000. This means the vehicle will depreciate approximately $4,000 per year. The cost basis is $50,000 and the adjusted cost basis (if sold) is $10,000. However, after 10 years, the business sells the vehicle for $15,000. In this case, the IRS would "recapture" the $5,000 profit over the adjusted cost basis and tax would be owed on that amount.