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Succession Planning: Several Ways to Skin a Cat

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One of the issues most often encountered by the owner of a closely held business is succession planning. This may be especially difficult where no member of the owner's family is involved in the business. In that case, the owner may have to consider the liquidation of his interest in the business, either by way of a sale to a third party or by a redemption of his interest by the business itself. In either scenario, in order to maximize the net economic benefit of such a sale or redemption, it may be necessary to secure the ongoing employment of certain key employees of the business.

The Transaction

In a recent ruling, the IRS considered such a scenario. A corporation had two equal shareholders. They wished to retire and transfer the ownership and operation of the corporation to four key employees who were unrelated to the shareholders.

They proposed the following transaction: the corporation would redeem all of their shares in exchange for promissory notes. The redemption price was determined by a third-party appraisal; the notes required periodic payments of principal and interest (at a rate in excess of the AFR) over a period of no more than nine years; the payments were not contingent on future earnings or any other similar contingency; the notes were not subordinated to the claims of general creditors of the corporation; the corporation's stock was not held as security for the notes.

The Employee Shares

Immediately afterward, the corporation would issue shares of its stock to each of the four key employees. The shares would be subject to transfer restrictions and service-related risks of forfeiture; in other words, the employees could not freely dispose of the shares and, if they failed to satisfy certain service-related requirements, they would have to return the shares to the corporation.

Following these transactions, the only outstanding shares of corporation stock would be those owned by the key employees. The departing shareholders, however, would remain employees of the corporation for a period of time, and they would continue to serve as chairman and vice-chairman of its board of directors.

In general, an employee's receipt of shares in the employer-corporation would not be immediately taxable to the employee provided the shares were subject to a substantial risk of forfeiture; the taxable event would occur upon the lapse of the risk of forfeiture. However, in the scenario considered by the ruling, as a condition to receiving the shares of stock, each key employee was required to elect, pursuant to Section 83(b) of the Code, to include the value of such stock in income (as compensation) in the year the stock was received. (The ruling was silent as to whether the corporation was to "gross-up" the employees for the resulting tax liability.)

The Ruling

Based on the foregoing, the IRS ruled that the redemption of the shares held by the retiring shareholders would qualify as a complete termination of their interests in the corporation under Section 302(b) of the Code, the redemption would be treated as a sale, and the gain realized by

the shareholders would be treated as capital gain, which they would report on the installment method as principal payments were made on the notes. Interest payments received on the notes would be taxable as ordinary income and would be deductible by the corporation. None of these holdings was surprising. Nevertheless, the ruling is instructive.

"Security" Arrangement?

The ruling does not indicate the extent to which the term of the promissory notes overlapped with the period during which the risk of forfeiture as to the employees' shares remained outstanding. It is not unreasonable to assume, however, that they may have run contemporaneously. The fact that the key employees were required to elect under Section 83(b) to include in their income the value of the shares issued to them appears to have been intended to incentivize the employees to remain with the corporation, by having caused them to incur an immediate tax liability (an economic cost) with respect to the shares. It also gave them the prospect of capital gain (as opposed to ordinary income) treatment on a sale of their shares after the termination of the forfeiture period. The transfer restrictions, plus the risks of forfeiture attached to the shares, which would cause the employees to forfeit the shares if they left the corporation before the expiration of a specified period of employment, or if they failed to satisfy certain performance targets (each a substantial risk of forfeiture), provided an additional incentive for the employees to remain with the corporation until the lapse of the risks of forfeiture.

The continuing presence of the two former shareholders as employees of the corporation, and as members of its board of directors, not only ensured them an additional stream of income, but also afforded them the ability to oversee the performance of the four key employees.

These "security" arrangements for the payment of the promissory notes issued by the corporation, which depended on the performance of the corporation, appear to have been a key element of the buyout.

Take-Away

The buyout arrangement described in the ruling appears to offer a viable and reasonable succession plan, at least for the subject business. It provided liquidity for the departing shareholders, a measure of security for the payment of the purchase price for their shares, installment reporting (i.e., deferral) for their gain realized on the redemption, and an opportunity for the key employees to assume control and ownership of the business.

Of course, every closely held business is different, and every owner faces a somewhat unique set of circumstances, and has his or her own particular goals. However, as the ruling demonstrates, there is a set of basic "tools" and principles which provide a common denominator from which an appropriate plan may be structured and implemented to suit the particular business and owner. The ruling sets forth just one of many possible permutations.