

**Notre Dame Tax & Estate Planning Institute**  
**November 9-11, 2022**

*I Like My Business Best,  
My Employees Second Best, and  
the Government Not at All: How  
to Consider Employees and a  
Company Legacy in the Estate  
Plan*

**10:20-11:20am/Session 4B (60 mins)**  
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The starting point for the analysis is a recognition by the business owner as to what, if any portion, of the business that the business owner (let's call them the "owner") would like to leave to the owner's family.

We know from clients that occasionally the business itself will take on the role of a family member, in priority to other family members. And the employees may also take priority over other family members. There is a cadence to the planning in these situations, and a protocol as to how to discuss and arrive at strategies to achieve the owner's objectives.

The first step is to arrive at that intent. Consider the following hierarchy to get there. First, what is the value of the business, and the relative value of the business as to the owner's other assets. This is critical for the planner to understand objectively what should occur in the planning process. For example, the business is 50 % of the owner's net worth; therefore, how does that play with regard to the other 50 % in terms of non business beneficiaries-the family? And how does play with regard to estate taxes and payments (more on this later).

Second, what is the owner's goal for the business. This will either be long term continuation of the business, or eventual sale. If a liquidity event will occur, there are strategies, estate planning and tax apportionment, that can be dealt with in our traditional estate planning ways.

Alternatively, and seemingly often, owners would like to have their business provide a legacy. For whom? That is a more difficult question, but the owner likes the idea of business continuity. **That then becomes the topic for this session.**

In that event, the next question and review is who is going to run the business. The owner may have no immediate answer to that question. So as not to remain stagnant, that question can be reduced to the question of who will have *control* of the business.

If control is to remain in the family, we are back in the realm of typical estate planning strategies. In particular, bifurcation of equity into voting, represented by a small portion of the equity, and non-voting, represented by the substantial portion of the equity (95 % for example). Estate planning discussions then devolve into who has voting, who has non voting, how to minimize taxes, equalization among family members, and puts and calls in non voting equity members to avoid disputes.

If control is to venture to employees outside of the family, this presents a unique challenge in structuring, especially if the non voting is going to remain with the family. In that event, accountability, safeguards, and pragmatics need to be considered as to whether this approach will be sustainable. For example, why would an employee want a 5 % equity stake, but 100% of the control? What is their incentive to maximize company value? Though we have seen this structure, the structure seems awkward and difficult to implement in a Pareto Optimal (all parties' interests are maximized) fashion.

We should encourage the owner to think of alternative structures if the owner's goal is to leave control of the Company with the employees. To avoid the awkwardness of the voting

(employees at 5%)/non voting (family at 95 %) structure, the next question is whether the family or the employees are to benefit from *most of the* Company equity.

If the answer is *the family*, then the planning discussed (on the attached and at the presentation) needs to consider the actual structuring alternatives PLUS implement estate tax planning during life, if needed. If needed of course refers to a situation where there will be an estate tax. And the estate tax planning will involve the transfer of a substantial portion of the equity, during the owner's life, to the family. These will include the typical planning strategies, discussed in more detail in the slides during the presentation, that are used in estate planning. These include straight credit shelter gifting, sales to grantor trusts, grantor retained annuity trusts, and preferred freezes under Code section 2701 (not available with S corporations). The strategies will involve discounted gifting on non voting equity interests.

If the answer is *the employees*, then estate tax planning may still be needed as an adjunct to the structure of ownership to the employees.

Whether equity value will pass *to the family* or *to the employees*, discussions will focus on how to get the business to the employees during the owner's life. If the business is going to the employees at the owner's death, then the discussion involves more typical estate planning. There, a focus on apportionment of estate taxes, as well as liquidity to pay estate taxes, are factors to be evaluated in the planning, and discussed during life.

For the remainder of this presentation, we want to focus on the situation in which the owner desires to pass control of the business to employees during the owner's life, equity to employees or the family, and the structures that can achieve that, as well as the estate tax planning strategies that should be considered.

The attached article provides a outline of the structures, and the power point and presentation will focus on and further explain these structures and the incorporation of estate tax planning in the implantation of the transfers.

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# Evaluating the Estate Planning Alternatives for Passing on the Business to Key Employees

When a business owner desires to pass on an operating business to loyal and key employees, there are several available alternatives to evaluate. In general, the alternatives are:

1. Sell the business to the employees for cash.
2. Sell the business to the employees, taking back the employees' promissory note.
3. Give the employees an ownership interest in the business as compensation for services.
4. Finance the immediate purchase of the business using an ESOP.
5. Reorganize the operating business as a partnership with one class of partnership interests, giving the key employees a % interest in profits without the employees having to make a capital contribution.
6. Reorganize the operating business as a partnership, giving the business owner a preferred partnership interest and the key employees a common interest without the employees having to make a capital contribution for their common interest.

Today's presentation will briefly evaluate how each alternative is structured. We will then describe the tax and financial impact for each alternative and the obstacles that can occur for each alternative, considering the personal, financial and tax objectives the business owner and the employees desire to achieve. We will mainly focus on using the preferred partnership alternative as we feel it may be best suited to accomplish the business and financial objectives for both the business owner and the key employee who will take over the business. For the business owner, the preferred partnership alternative to a buyout has income tax benefits and financial benefits that are not available with a buyout and that can be attractive even if the business owner is not exposed to the estate tax.

## Background

If an individual has a closely held business and none of the children work in the field and the individual is not wealthy enough to give the business away, what should the individual do? Assume Senior wholly owns a successful dental practice and wants to retire sometime in the future. Senior is considering a buyout where Senior will sell the practice to Junior, a dentist who has been working there for the past 10 years. Junior and Senior agree that the dental practice is valued at \$1,500,000. Senior's income tax basis for the business is zero because all the tangible assets have been fully depreciated and the primary asset is an intangible, self-generated goodwill. After Junior takes over the business, Senior plans to continue to practice after passing on the ownership to the Junior but will gradually wind down from a full-time commitment to part-time to fully retiring. Mr. and Mrs. Senior will need some form of income from the business or from the sale price to fund their retirement.

The objectives are to design a succession plan that can accomplish the business and financial objectives for both the business owner and the key employee who will take over the business. Specifically, the objectives for the Senior are what steps to take to pass down the business to the key employee, including going over potential income tax problems. Proposed buyout alternatives will cover financial benefits that are attractive to the business owner even if they are not exposed to estate tax. Specifically in this scenario, ways in which the Senior can have a rate of return from the entire \$1,500,000 gain for the rest of the Senior's and their spouse's life and never have to report the gain.

### **Scenario 1: Purchasing Outright with Cash**

In this scenario, the Junior plans to buy the practice outright in cash. When the Junior does so, the Senior will receive the \$1.5 million in cash and have to report it as capital gain. This means the Senior has to pay 25% state and federal income taxes, which is equivalent to \$375,000, netting a total of \$1,125,000. The Senior can then invest the net cash taxes at 5% rate of return to supplement income to fund the Senior's retirement. The 5% return on the \$1,125,000 is a \$56,250 annual income for the Senior. But, where will the Junior find the cash to fund the buyout?

### **Scenario 2: Using a Promissory Note (Installment Sale under Section 453(a))**

Since Junior most likely does not have the cash on hand to buy out the Senior immediately and the business will not make the \$1.5 million up-front, the Junior can use a promissory note to wait to pay the cash in the future. This way, Senior can fund the Junior's entire purchase by taking back the promissory note for the entire purchase price. Now, the Senior does not have to report the \$1.5 million gain realized on the sale until the principal payments of the promissory notes are received for federal income tax purposes, and does not have to pay taxes on the total immediately. Instead of the Senior investing the net gain of \$1.5 million, they can finance Junior's entire purchase price by having Junior issuing a promissory note that pays 5% annual interest. Over the course of 5 or 10 years, the promissory note will be paid off in equal, annual payments. This is a more favorable method of payment because it can be prepaid at any time.

But, in this scenario there will be no step-up basis at death, which means the cost basis will not be adjusted to the fair market value at the time of the descendant's death. The \$1,500,000 promissory note is income in respect of a decedent and takes a carryover basis if Senior dies with the note outstanding.

### **Concerns**

1. Financial Concerns of the Junior: Will the practice generate enough excess cash after the income taxes and the Junior's salary for the Junior to pay back the bank loan or the interest and principal on the promissory note?

2. Business Concerns: How will the Senior be compensated for the work they do after the Junior purchases the practice? At the beginning both the Senior and the Junior will be full-time at the dental practice, so how will the business replace the Senior as the Senior gradually retires?

3. Other Concerns: The Junior does not have the immediate cash to pay the Senior and does not want the pressure of paying off both the principal and interest of a bank loan, so what is an alternative to this?

A solution to address all of these concerns is using a preferred partnership. This means the Senior will own the dental practice under a wholly owned S corporation or a partnership. This structure works no matter how the business is owned.

If the business is owned under an S corporation and the Senior owns 100% of its stock, the S corporation will form a partnership. The S corporation will contribute the value of the business to the partnership to a capital account. This means the preferred partnership interest that the S corporation receives is going to get priority allocation of profits, allowing the Junior to join the partnership without having to make a capital contribution.

The Junior is not a family member so special rules for preferred partnerships and internal revenue codes do not apply. But, this means the Junior needs to be given a guaranteed salary that is treated as an operating expense that is a deduction used to compute taxable income.

The preferred partnership works by giving the senior 6% priority allocation. It is similar to buying a bond for \$1.5 million and paying 6% interest annually, but one does not have to pay off principle. This 6% is equal to \$90,000. Preferred priority does not have to be paid if cash flow is not enough as well. Preferred shortfall can instead accumulate in the arrears and be made up in the future as cash flow increases. This gives the Junior flexibility to gradually redeem the Senior's preferred capital account from excess cash made by the business or through borrowing cash.

In this preferred common partnership, the first \$90,000 made in the business will be allocated to the preferred and any income made after the \$90,000 benchmark is surpassed will be allocated to the common; the preferred interest is owned by Senior and Junior owns the common interest. Since Senior will be decreasing his working hours, there will be a reduction in his draw, and this money will be allocated towards the instead, guaranteeing they are paid. This means Junior will be paid regardless of what the business makes in a year, which then allows the partnership to get a deduction, which is the equivalent of a salary for the Junior.

Now, the Junior does not have to come up with the cash to pay back the Senior because the Senior is receiving a form of salary through the preferred partnership. But, eventually the Junior would like to get rid the Senior's preferred interest. This will give the Junior flexibility to gradually distribute excess cash made by the business to be applied to the total that the Senior put down as capital contribution to the partnership. The financial advantage in this situation is that the Junior can buy out Senior's preferred interest only if the business has an increase in cash flow when the Senior's preferred partnership interest is being redeemed. But, if the preferred interest is redeemed while the Senior is still alive, they will have zero basis in the \$1.5 million preferred interest.

Giving the Senior preferred interest also gives them an asset that can be discounted for estate planning. If the Senior continues to hold up preferred interest they will receive a tax-free step-up basis at death. This is because the installment note is IRD, Income in Respect of a Decedent, means it is untaxed income that a decedent has earned or has the right to earn in their

lifetime. An IRD can lead to a double tax hit because it counts towards the decedent's estate for federal tax purposes, but the beneficiary may be able to take a tax deduction from the estate tax already paid on the IRD.

The Senior can also gift the preferred interest in a non-grantor trust and assign the \$90,000 annual taxable income to trust beneficiaries, such as children and grandchildren in low income tax bracket. This allows the Senior to take advantage of the \$2,300 of passive income taxable at 5% under the kiddie tax. It is advisable to not gift the installment note because it results all deferred gain to be immediately reported upon the gift.

Another possible scenario is what if the Junior is obligated to redeem the Senior's preferred interest. In this situation, to take advantage of the income tax-free step-up in basis at death, do not let the Junior redeem the preferred interest until after the Senior and their spouse pass away. Upon the death of the Senior and their spouse, their children or inheritors can decide whether to continue to receive the preferred interest or require the Junior to redeem the preferred interest.

A question posed is whether the Senior should be given a put right for the Junior to redeem the Senior's preferred interest while the Senior is still living? This depends on the future state of the market because a put right is putting the option in a contract to give the holder the right but not the obligation to sell a specific amount of an asset at a set price and at a specific time. Put rights are normally put into place if it is thought the underlying asset will drop below the original price before the expiration date.

A scenario to better explain this situation is say in year four or five of the Junior being in the partnership, the Junior has an excess of \$200,000 and uses it to redeem the Senior's \$1.5 million preferred account, reducing it to \$1.3 million. This means the Junior will have to report the \$200,000 capital gain. After this payment is made the Senior has preferred interest in the partnership, but it is not already marketable. This is because the Senior's ownership stake in the business is not liquid. The Senior also does not have absolute control over the business, so they can eventually discount the preferred partnership to \$1.3 million. When the Senior converts their ownership stake into preferred interest there will be no sale, just deferred under the installment method until principle payments on the note are paid. There will also be a conversion from regular interest to preferred interest.

This conversion to preferred interest will make sure the \$1.5 million is entitled to step-up and basis at death. Senior has to die with this preferred interest included in the gross estate.