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Business Structuring Choices in Succession Planning

Take another look at the title to this article. The key word is "choices."

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With sufficient time and with thinking that is both critical and creative, the transfer of a company will be smoother and less expensive if business owners and advisors are willing to consider all of the options available. In part, the choices include what type of entity should own the business. At another level, attention must be drawn to both the entity's operations and management today and to its likely activities and control tomorrow. A combination of planning for both the present and future determines which of the choices should be selected.

What Type of Entity to Select

With user-friendly websites, many Secretaries of State have made the formation of entities easy and inexpensive. You don't need a lawyer to file incorporation or limited liability company formation documents. Anyone can go online and form an entity. Many of the old formalities and paperwork are gone.

While the formation process is routine, formation is not the critical activity. The essential question is what type of entity suits the client's situation best. For that answer, no generalizations or form books will work: look at the client's business, family and business associates and evaluate the situation based upon the particular set of facts and relationships.

Entity selection is not just a one-time decision. Even after a company begins operations, it may be wise to adjust or change the business entity's form. What worked well at the time of formation may not be the best for a maturing business or for one that is being prepared for a transition. The situation might call for a corporation to elect into or out of S Corporation status, or for a corporation to become a limited liability company, or perhaps to have stock transferred to a trust. Sometimes, a formal conversion under state law is possible, but in other situations that is not necessary. For example, parents may wish to gift corporate shares to their children without also giving them the rights to inspect the company books or to vote. Therefore, rather than give the shares of stock to the children, the parent might want to contribute the stock to a family limited partnership, in which the parent retains all of the general partnership (voting) interests, and the children are given only limited partnership (non-voting) interests. As general partners, the parents retain full authority to manage the business, while beginning to allocate some ownership to the children, thereby reducing the family's overall income and estate tax liability. This is just one way to adjust as the business and family needs arise.

While the family limited partnership works well when there is at least one owner-operator, it may not work as well with a business in which a non-owner is the chief operating officer. For such situations a limited liability company or corporation will be a better selection, since authority and personal liability is not directly tied to ownership. A non-owner manager or president can be selected, while the governance rights of the general partner can be mimicked through the use of voting and non-voting ownership interests.

Operations and Management of the Entity

In some situations, lenders or others may require the use of outside, independent advisors. While any form of entity can retain outside consultants, corporate boards of directors provide a well-recognized structure in which board members have established legal obligations to the corporation and its shareholders. The fiduciary responsibilities placed on the directors may make the corporation the best selection in such cases.

In addition to matters of corporate governance, careful consideration should be given to whether all divisions of a business should be included within a single entity. For instance, a multi-talented founder may have a hard time finding a single successor with comparable and varied skills. When it comes to turning over the reins of such a complex business, having multiple entities may facilitate smoother transitions, since each division may have to be transferred to a different person.

Business Structuring's Impact on Taxes

Often taxes are the central focus when choosing an entity and structure. At one time, a taxpaying corporation was the only likely alternative to operating as a partnership or sole proprietorship. Taxpaying corporations have the potential for double taxation: both at the entity level and at the shareholder level. Now there are S corporations and limited liability companies, both of which file income tax returns, but neither of which normally pays any tax. These entities have only one level of taxation because the owners of those entities add their share of the business's income or loss to their personal income tax returns.

Consideration of corporations, however, should not be entirely ignored. For instance, under Section 1244 of the Internal Revenue Code, losses on the stock of small business corporations (but not other entities) may be taken as an ordinary deduction, rather than the less beneficial capital loss deduction. Furthermore, some of the gain from the sale of certain small business corporate stock acquired over the last few years was not taxable. That benefit did not apply to non-corporate entities. It is possible that similar exclusions may exist in the future, so care should be given to what tax benefits are available to only specific forms of entities.

Importance of Continual Planning

Since taxes are an important consideration--even if not the only one--we must recognize the significance of the fact that the tax law has changed with regularity over the last several years. Assume that change will be a constant occurrence in the future, and that whatever planning is done may have to be undone. Therefore, flexibility must be a key goal. However well-reasoned the original analysis may have been, we must be able to change our strategy to a changing world. There are already tools to help with such an adjustment, such as the IRS "check-the-box" regulations and the ability to elect S corporation status. Wise planners always are looking for the need and opportunity to turn onto a different road in order to reach the client's destination.

Owners and their advisors continually need to evaluate their businesses and the law to find the best opportunities in times of change and to improve financial and operational results. Having or securing the needed knowledge, and then making the right choices is what makes succession planning both profitable and fulfilling.

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