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Business succession planning
Cultivating enduring value

Volume 2

Establishing a foundation

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Establishing a foundation

Succession planning means different things to different people: it can be as simple as naming a family member to take over, or as complex as overhauling the structure of the business to align it with long-term objectives. Many businesses don't pay enough attention to succession planning in any sense of the term. Still fewer see the true scope of the challenge. Effective succession planning isn't only about deciding who will run the business — it's just as important to determine what kind of business those people will run.

This thinking can upset the assumptions owners may have held for a long time. A business may have operated for years as a sole proprietorship or a closed partnership. But will it continue to operate in that form? A business owner may have his or her own sense of what the business is worth — but what is it worth to other people, with other perspectives, in other circumstances? Some may assume succession doesn't cost anything if all they think it involves is handing over the keys. Yet in practice, moving a business into its next generation of ownership can impose significant costs, some of which require significant liquidity. Without foresight and planning, the cash may not be there when it's needed.

The ultimate goal of succession planning is to understand the value of the business, to preserve its value and future growth potential, and to pass it forward intact. There is no doubt it is important to pass the business on to effective successors. But before anyone gets a new parking space, the current generation of leadership has a lot of work to do.

This paper is part of a series on the challenges and opportunities of succession planning for privately held organizations which may include closely held, single-proprietor, or family businesses. Companion volumes will explore personal wealth management, business governance, family dynamics, advisors, and the creation of a legacy. Depending upon the long-term goals of a company's stakeholders, elements like these must often work together. This volume focuses on a central concern: No matter who is in charge, every business owner wants to see his/her enterprise keep creating and accumulating value.

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Form and function
Choosing the appropriate entity structure

Entity structure is a fairly straightforward choice for public companies, which are almost always C corporations because that legal structure allows the entity to be separate and apart from its shareholders, directors, and officers.

Closely held businesses have more choices to make — which can complicate the decision process. Succession planning isn't the only factor that determines which structure suits the company's long-term needs. Exposure to liability, access to capital, and the personal financial needs of the owner and other stakeholders all enter the equation.

Entity structure is a necessary part of any plan to move into a new generation of ownership because it has a significant effect on business taxation, personal taxation, and the company's ability to transfer wealth. In addition to sole proprietorships, closely held businesses can choose from many different structures. For a business to match its structure to its future needs, it is worth examining the pros and cons of several potential forms: partnerships and limited liability companies, S corporations, and C corporations.

Remember that a succession process involves more than one kind of stakeholder. There are the significant owner-managers who no longer want active participation in the business, and are likely to want to monetize their investment, and then there are the people who intend to remain with the business and continue to contribute to its success. The tax and other implications of an entity structure choice will generally affect the fortunes of both these groups, and this decision has a lasting impact on future options for business succession. This discussion will guide you through the various choices to consider and how they can affect long-term plans.

Partnerships and limited liability companies

As with the other entity choices for closely held business owners, there are both tax and non-tax reasons to conduct business as a partnership. The biggest disadvantage for partnerships is that the general partners have unlimited personal liability that can affect their personal assets. However, in a limited rather than general partnership structure, a limited partner is typically only at risk to the extent of his or her investment. For this reason alone, many owners choose not to operate a business as a general partnership.

However, the recent development of the limited liability company (LLC) — which affords the corporate "veil of protection" but is taxed like a partnership — has changed the liability issue.

What's the appropriate entity structure? The choice depends on what a company's stakeholders want to achieve. It also depends on the makeup of the ownership and management teams, as well as the company's overall strategic plan.

Often, the better structure will become apparent when viewed through the lens of estate planning — such as when owners use a family limited partnership to help reduce the tax liability when they transfer wealth from one generation to another. Stock transfer techniques can also overlap with structuring objectives, as in the case of an employee stock ownership plan (ESOP). Choosing one corporate structure over another may enhance the tax benefit of certain compensation plans. The ability to conduct future tax-free stock swaps, or the expectation of a public offering are also potential considerations.

Looking for more technical details on the various entity choices and their pros and cons? Read "In the details" at the end of this volume.

S corporations

An S corporation is a separate legal entity in the same way a C corporation is. But instead of paying federal corporate income taxes, it functions as a "pass-through"— dividing income or losses among its shareholders, who then pay taxes on any gains as part of their personal income.

The decision to convert to S corporation status can make things more complex for a company and its owners, assuming the organization meets the requirements for that standard in the first place (it must be an individual or certified trust with no more than 100 shareholders). But this type of conversion can also help contribute to an effective succession plan. That's because pass-through entities allow tax advantages in many ownership transfer plans. To preserve these advantages, it may be a good idea for S corporation shareholders to lock in their status with agreements and policies that keep the corporate structure from being terminated without their consent.

When a business is transferred to a new generation of ownership, the way taxes affect that transfer of value — for both the company and the individual stakeholders — can make a significant difference in how much value endures. Choosing an S corporation brings a number of complications that affect companies in the near term, as they work to address tax planning. The effect of a pass-through structure on eventual succession should be a consideration in the way any closely held company approaches its long-term plans.

C corporations

A C corporation is a legal entity that is separate from its owners. This gives both the company and the owners certain advantages in taxation, liability, and other areas. A C corporation is a common business entity choice for large, publicly owned companies, and can sometimes be a useful choice for private businesses.

When business succession plans are on the table, taxation is important. It's likely the reason a business owner chose the company's existing entity structure. But the decision to "go corporate" often revolves around liability as well. Because a C corporation is a separate legal and taxable entity, it can help give business owners a firewall against both legal and financial exposure that partnerships and sole proprietorships may not. No matter how deeply a person identifies with his or her business, it can be beneficial to keep one's personal affairs separate from the corporate entity.

However, it is important to remember that choosing a corporate structure can add compliance costs, such as SEC and Sarbanes-Oxley reporting requirements for public C corporations. In some cases, a closely held C corporation may actually experience some tax disadvantages.

Alternatively, limited liability companies allow some of the same protections for business owners as a C corporation — similar isolation between personal and corporate affairs, including legal and financial exposure — but that form of entity is relatively new and still comparatively untested in the courts. C corporations have been around for a long time, and many individuals feel more comfortable with a familiar model.

Other reasons to operate as a C corporation may involve future plans to expand or to acquire stock. Rules limit how many shareholders an S corporation can have — and if a company with multiple generations of owners exceeds this limit, it may find a C corporation a workable alternative. A C corporation can also help a company achieve tax-preferred treatment in cases such as the sale of stock to an employee stock ownership plan, in which case that structure can help the owner defer capital gain.

Implications for succession planning

The choice of an entity structure can change the complexion of a succession process in a number of ways. If the current ownership wants its heirs to own and run the business later on, a pass-through entity such as a partnership or S corporation may make it easier to move money from entity to shareholder and transfer full or partial ownership interests with less tax and regulatory difficulty. On the other hand, a business that sees its future in an initial public offering (IPO) might prefer the traditional benefits of a C corporation.

No matter what future a business envisions, a structure that helps a company and its stakeholders grow, keep, and transfer value in alignment with its long-term strategy is a foundational piece of the succession planning puzzle.

What's the appropriate entity structure? The choice depends on what a company's stakeholders want to achieve.

What it's all worth
Business valuation

The value of a business has a profound impact on many succession planning issues, including retirement plans, gift and estate taxes, compensation levels, insurance, agreements among shareholders, and corporate finance strategies.

To move forward effectively, any decision about succession planning needs to incorporate an accurate plan for valuing the business. While the process of determining valuation for closely held businesses has a basis rooted in professional standards and methodologies, in reality, it can be as much an art as a science.

Measuring value in a closely held business

Assets like cars or real estate are easier to value because there is an active secondary market for them and there are comparable sales to help determine what they're worth. But there is no widespread secondary market for closely held business interests, and businesses are seldom similar enough for comparable sales to help an appraiser. That's why appraisers must turn to other methodologies to approximate the value of a business.

It's generally accepted that there are three basic ways to describe the value of a business: fair market value, investment value, and liquidation value.

Fair market value. This is the hypothetical cash exchange price that a willing buyer and seller would agree upon as payment for the company with mutual knowledge of all the relevant facts.

Investment value. This is the value the business represents to a specific investor — a successor in a family business or a competitor looking for a company to buy — and incorporates specific considerations above and beyond the fair market value cited above.

Liquidation value. This value is based on the assumption that the business is no longer viable — worth more dead than alive — and the owner is compelled to sell its assets piecemeal.

Sometimes, a valuation report on a company will include analyses that use two or more of the values defined above. For example, a business owner contemplating the sale of his business may want to compare the fair market value of the business to the investment value a synergistic strategic purchaser or family member might offer.

To move forward effectively, any decision about succession planning needs to incorporate an accurate plan for valuing the business.

Digging deeper: A detailed look at standards for evaluating business value

Fair market value

If there were a broad market for the business, this is the price that the market forces of supply and demand would arrive at. It assumes all of the parties are acting freely, without any duress or compulsion. If there are no recent bona fide offers from unrelated parties, the valuation professional is left to speculate on what a hypothetical buyer would pay. The IRS regulations follow this basic premise for valuation.

Several factors can diminish the fair market value of a stakeholder's interest in a closely held business. For example, the interest may or may not include voting rights, and voting stock would be more valuable than nonvoting stock. Or if the amount of voting stock offered for sale is not enough to gain voting control over an existing majority owner, that minority interest would not be worth as much per share as the majority interest. Stockholder agreements may constrain value by restricting the transfer of ownership to other individuals. As a result, there may be no readily available secondary market for the shares, especially for minority shareholders, because a strategic buyer may not be interested in purchasing anything less than a controlling position in the company.

Investment value

Because this method of valuation depends on the interests of an individual investor, it can vary widely from case to case. It's based on a potential buyer's investment requirements and expectations. The investment value may change based upon intangible factors, such as the brand value attached to a long tradition of family ownership, or possible synergies a strategic buyer of the business might achieve.

For example, a strategic buyer may be a competing corporation with enough administrative infrastructure capacity to run both companies. When they combine, administrative costs in the acquired company potentially could be eliminated, resulting in greater profit than what the two separate competing entities generated before.

Liquidation value

When a defunct company is being broken down into saleable assets, the expected timing of the liquidation can affect this valuation method. In a forced, immediate liquidation, for example, assets might diminish in value because there isn't time to shop them around to several potential buyers. Alternatively, a more orderly, less hurried liquidation could bring a higher sales price.

Creating value in a closely held business

Value is not determined solely by present-day cash flow. In fact, the prospect of future cash flows matters more; so do prospects for future growth. Investors value investments based on the returns they can expect over the lifespan of the investment.

For a closely held business, cash flow can include dividends, salaries and benefits for owners, and projected sale or liquidation proceeds. That's why those who evaluate deals — including investment bankers, valuation professionals and equity analysts, as well as business owners and operators who actually acquire businesses — use expected future cash flows to estimate the current value of a company. Many factors affect the value of the cash flow stream: the current cost of capital, the timing of the cash receipts, the expected growth or decline of the cash stream over time, and the risk that the expected cash flow stream will not be achieved.

Valuation specialists consider many other factors while deciding on possible future cash flows, including:

- Earnings history and nature of the business
- Industry and general economic conditions
- Company financial condition, net worth, value of non-operating assets and intangible value
- Current and estimated future market share
- Earnings capacity of the subject company and similar companies
- Dividend capacity of the subject company and similar companies
- Size of the interest offered by the subject company

Methods to calculate value

Generally, those valuing businesses choose from among three approaches when preparing their analyses: the income approach, the market approach, and the cost approach.

The valuing of a business may involve one or more of these valuation approaches. For example, the valuation professionals may use the income approach to appraise the value of business operations, then use the market approach as a "reality check" to verify the results from the income approach.

Income-based approach

This approach estimates the value of business operations based upon the present value of expected future cash flows or operating income. Many argue that it provides the most accurate value, because investors buy based on expected returns.

Market-based approach

The market-based approach is grounded in "real-world" transactions — it estimates value of the subject company by comparing the market price of comparable companies. However, as previously noted, among closely held businesses, comparable companies can be hard to find. For this reason, professionals often turn to market-based multiples, such as price/earnings ratios, then adjust these multiples for differences in risk and growth potential between the subject company and the guideline companies. Generally, the more similar the companies being compared are, the better the valuation guidelines will be using the market-based approach.

Value is not determined solely by present-day cash flow. In fact, the prospect of future cash flows matters more.

Cost-based approach

The cost-based approach estimates a value based on the fair market value of a company's assets, minus the fair market value of its liabilities. The cost approach may be hard to apply to many businesses, because many of their most important assets are often intangible.

These are broad categories. In practice, the details of a particular transaction can adjust a business' value up or down, no matter which valuation approach and methodology are utilized.

Valuation discounts

Another way experts can fine-tune their judgment of a company's value is to compare closely held business interests with other investment types. They apply value reductions, or discounts, to account for certain disadvantages that are inherent in owning closely held stock. For example, the benefit derived from some estate and gift tax strategies relies heavily on these discount factors.

If a company is too aggressive in using these discounts to try to depress the value of a business interest and save on taxes when it's transferred to new ownership, the IRS may challenge the result. In particular, the IRS has taken a close look at discounts used in family limited partnerships — a way to transfer ownership in a family business that has become increasingly popular. When a business of any type uses valuation discounts in a succession plan, a formal discount study should be prepared by a credible valuation specialist. This study will help set the appropriate discount and provide analytical support which may be used to defend against an IRS challenge.

There are several types of valuation discounts:

Control discounts

If a shareholder of a closely held company has a majority control of the voting stock of the company, that individual can dictate major business decisions. Since a minority shareholder holds this type of authority, his or her interest would not be as valuable as that of someone with majority control, and this is taken into account.

Lack of marketability discounts

A ready market of willing buyers for a person's interest in the company would generally enhance the market value of the investment. Conversely, if there isn't a ready market, the investment is typically less desirable, and a marketability discount may apply.

Blockage discounts

Sometimes, a company's stock has a ready market, but the block being valued is too large to sell readily. In these cases, a blockage discount would be factored into the valuation to account for this disadvantage.

Stock restrictions

Some closely held companies have rules or agreements that restrict the stock so it can only be sold back to the company, or to the other owners. Limiting a shareholder's options this way often makes the ownership of the stock less desirable, and could trigger an adjustment during valuation.

Implications for succession planning

Only by understanding the true value of an enterprise can a business owner make appropriate long-term plans for it. And even for a business that appears simple, valuation can be fairly complex. In separate conversations during one recent transaction, a company's CEO named a ballpark figure three times the amount the same company's CFO put on the table. At some point, a company's leaders need a common, data-driven approach to determine whether it's the appropriate time to sell or whether they should remain engaged and continue to build value.

Valuation also affects the smoothness and efficiency of transfers as part of succession and also can help parties save money by transferring shares at defensible discounted values for tax purposes.

If a business doesn't start taking valuation seriously until a sale or transfer is at hand, it can diminish the effectiveness of succession planning. Another important benefit of understanding the value of a business is that a constant, objective sense of valuation helps leaders make better decisions as they run the business day-to-day — knowing not just what the company is worth, but what's driving the growth of that worth.

Liquid gold
Corporate finance

Many ownership succession plans lead to the company's ownership being divided, transferred, or consolidated. Making changes like that usually requires cash. The simple vision of handing over the keys is seldom realistic. Some closely held companies may be able to fund their succession plans on their own. But when the process requires a cash payout to existing shareholders that is more than a company has available, it has to turn to external funding sources.

Fortunately for these businesses, the variety of financing sources is greater today than in prior eras. Financial institutions have expanded their services broadly, and more types of organizations compete for this financing business — including commercial banks, leasing companies, mezzanine and private equity funds, and even venture capitalists. Access to alternative outside resources, such as foreign investors and strategic alliances, also may be an option.

There are two basic financing alternatives available to businesses: debt and equity. Debt is simply a loan, with a promise to repay the funds borrowed, plus interest, over a designated period of time. Equity financing involves the sale of an ownership share in the company to another party. There are advantages to using either form of financing. The appropriate answer for a company depends on the specific circumstances at hand and the way the choice interacts with other elements of the succession plan.

Two ways to raise cash for succession planning

Advantages of debt financing

- Debt financing is finite — the company's obligation to the lender ends when the debt is repaid, and the owner retains control of the business.
- Depending on the strength of the business and the preferences of the owners, some forms of debt can be secured or unsecured and have various levels of covenants to assist owners in navigating potential unexpected events.
- The interest payments on corporate debt are generally tax deductible, which can lower the net effective cost of borrowing the funds.
- Recent relatively low interest rates make debt financing even more attractive. Inflation may make the effective cost of borrowing even lower, because the company pays off its debt in future dollars.

Advantages of equity financing

- Money received by the company stays in the company. There is no commitment to make future repayments of cash.
- Maximizes financial flexibility in the event of a slowdown in operating performance.
- Multiple classes of stock (voting and nonvoting) may allow companies to receive an injection of cash from outside investors without giving up management control of the company.
- Some companies simply do not have the capacity to incur additional debt, which generally leaves equity financing as the most viable alternative.

While examining these various funding alternatives, it is important to remember that the people and institutions that provide the capital all share one basic strategy. When someone gives a company money, he or she expects to be repaid in the future with a reasonable rate of return. This rate of return translates into the cost the company pays for borrowing the money it requires. The amount of risk perceived in a business — that is, the calculated probability that a company will succeed — is one of the main factors that will determine the cost of capital invested by third parties.

Cost of capital

Another important factor in determining the cost of capital is the prime interest rate commercial banks charge. Many banks publish these prime rates, and they can change at any time. Originally, this was the interest rate banks charged to their lowest-risk or "prime" customers. In recent times, larger customers have been able to negotiate financing agreements with banks at rates below prime. Thus the prime rate, while still used as a lending benchmark, is somewhat mislabeled. In fact, some banks use the term "reference rate" instead.

How much risk will different capital sources accept? The answer varies dramatically with the nature of the financing they offer. As risks become greater, the lender expects a greater rate of return. Debt financing is generally viewed as lower risk capital to the investor because it is usually secured by a lien on the assets of the company. Unsecured senior debt typically will have priority over subordinated debt and equity positions, making it less risky than the latter two forms of capital. If the borrower defaults and is unable to repay the loan, the lender has first claim on the assets of the company.

At some point, the perceived risk reaches a level that forces the interest rate — the cost of money — so high the company is unable or unwilling to pay it. In this case, it may be necessary to sell part ownership in the company instead. Equity investors who buy part ownership can vary considerably in the amount of risk they are willing to assume. Investors in publicly held companies work to manage the risk on their investments by seeking entities with demonstrated track records. Venture capitalists, on the other hand, are willing to take greater risks, and often purchase equity in small or early-stage companies.

Implications for succession planning

Owners of closely held businesses often rely on those with whom they have built client service relationships over many years, such as a banker, lawyer or insurance broker. As a result, they may not always shop aggressively for a capital structure that gives them increased power and flexibility. More specifically, when a succession plan calls for financing, or for shifts in financial structure (for example, through a leveraged dividend or a minority equity investment), companies may limit their options by relying solely on historical relationships that might have served them during an earlier phase of their company's evolution.

If owners determine that their ultimate goal is to sell the business, implementing the appropriate capital structure can help the business weather storms before, during, and after the eventual handoff. It's important to approach finance with a long-term view.

How much risk will different capital sources accept? The answer varies dramatically with the nature of the financing they offer.

Conclusion

The way a business structures itself, assesses its value, and goes about obtaining capital all sound like here-and-now concerns. And they are: each of these disciplines is vital to the work of managing a business in the present day.

It's not always easy to see how these decisions influence business succession plans that may not take effect for many years. But they form the foundation on which those future plans will rest.

These types of decisions may lock in circumstances and compliance obligations that can have significant impact years later when it's time to transfer ownership. Each of these decisions has a profound material effect on the nature, value, and viability of the business and its ability to persevere under anyone's leadership.

Succession planning is a process, not an event. And that process starts for each business the moment it first opens its doors. Some businesses realize this. Other businesses file succession planning under "someday."
But someday typically arrives sooner than most business owners expect.

Case study

While the following scenarios are hypothetical, they are drawn from similar experiences that family businesses we work with have faced. They are intended to illustrate the pivotal role that decisions about entity structure, business valuation, and financing options can play in the succession planning process.

Different decisions, different outcomes

Forty-five years ago, two young professionals got their degrees and certifications at about the same time. They've spent the decades since in friendly competition — the city is big enough for both of them, they've kept each other on their toes, and each has seen their business grow steadily from a one-person shop to a thriving concern that employs dozens.

Now, retirement looms for both Seth and Kate. As part of growing consolidation in the industry, they're both receiving solicitations to sell their businesses to larger strategic buyers. In addition to securing the personal fruits of life after work, both of them want to keep the doors open for the younger people on their staffs.

Seth set his practice up as a C corporation many years ago because of the fundraising and liability advantages he saw in that model. He has always expressed the value of his business from an income-based point of view — he billed $18 million last year, so he considers himself to be the owner of "an $18 million business." Because he prefers to keep the business closely held despite the C designation, he used debt rather than sale of equity to fund a major expansion three years ago.

Kate had a partner for a time, and even though she bought her out more than 20 years ago, she has kept the business a Limited Liability Corporation. She has a financial advisor who occasionally updates her estimate of the business' value according to the income, market, and cost bases, so she's able to keep tabs of ups and downs. Kate has a line of credit that she's used as sparingly as possible by ramping her expansion and retooling needs through several incremental phases.

Seth just walked out of a meeting with his business advisors feeling shocked and disappointed. As it turns out, he may have to scale back his personal retirement plans, and his professional practice may be liquidated as part of its sale. Things might have been different if he were able to revert to an S corporation or sole proprietorship — that would have sped the transfer of ownership shares and spared both him and the company large tax bills — but it's too late to make that change. The debt he incurred expanding the business left it with no liquid room to maneuver in arranging a sale. Seth's biggest disappointment was learning that based on offers from potential buyers, his "$18 million business" was going to sell for no more than $7 million.

On the other side of town, Kate has found that the pass-through LLC structure left her many more options in transferring ownership of the company, and preserved more of her returns from taxation. She would have preferred a higher sale price — wouldn't anyone? — but the offer she accepted was in line with her expectations because she'd paid regular attention to valuation over the years. Finishing the deal will require some liquidity, but she's got plenty of credit available on favorable terms to see it through. With those concerns safely addressed and a well-funded retirement ahead, Kate plans to meet her husband at a travel agency on the way home from the meeting.

Analysis

The factors that made Seth's outcome so different from Kate's were rooted in decisions that appeared to have nothing to do with succession planning when they each made them years before the fact. Some business owners end up in a favorable position because they set up what turned out to be beneficial structures years ago without paying careful attention to the reasons. Others may rely on knowledge and experience — either their own or a consultant's. What's clear is that getting advice and putting in the time, money, and effort to plan ahead is an investment that can pay for itself many times over in the end.

In the details: Entity selection and business succession

Pros and cons of an LLC

Pros

Administrative simplicity. Partnerships are easier to set up than corporations and are generally less costly to administer.

Control over distributions. Partnerships can allocate items of income and expense among the individual partners in any manner the partners agree upon, subject to certain IRS guidelines. Partnerships can also make distributions of cash to partners that are not in direct proportion to ownership, while S corporation shareholders may only receive distributions in direct proportion to their stock ownership.

Deductibility of losses. If a partnership or LLC creates debt for the owners, they can deduct losses that debt generates even if the deduction exceeds their investment basis in the company. Generally, the IRS will only allow owners to deduct losses to the extent that they have "basis" — you can't write off two dollars of losses if you have only one dollar invested. But partnerships allow owners to count partnership debt as "skin in the game" if the partners are personally liable for the debt. This advantage may be less powerful under an LLC than under a general partnership, because the LLC's liability protection mitigates the personal risk that allows owners to deduct the losses.

Cons

FICA/self-employment taxes. S corporation shareholders pay FICA/self-employment taxes only on "reasonable compensation" paid to employee owners. Any profit distribution above that amount isn't subject to the tax. For partnerships and some LLCs, all income from the company is subject to the tax if the partner materially participates.

Treatment of losses. Section 1244 of the Internal Revenue Code allows a qualified small business owner to get ordinary loss treatment (rather than capital loss treatment) on a portion of the loss on the sale of stock when a shareholder sells his entire interest in the corporation. But the provisions of Section 1244 do not apply to partnerships or LLCs taxed as partnerships.

"Check-the-box" regulations. These IRS regulations allow an unincorporated business to select either pass-through treatment or regular corporate treatment by simply checking a box on an IRS form. If no box is checked, the regulations provide default treatment: to be treated as a pass-through LLC. These regulations reduce the threat the IRS would try to re-characterize a pass-through limited liability company as a regular C corporation and impose C corporation taxes. As a result, the popularity of LLCs has dramatically increased.

Pros and cons of an S corporation

Pros

No double taxation…

- On profits: S corporations avoid the double tax associated with C corporation dividends, because the individual shareholders of an S corporation report the annual corporate financial results as part of their personal income rather than as dividends.
- On proceeds: When a C corporation holds appreciated assets such as real estate, its shareholders face double taxation on the gain from the sale of those assets, as described above. S corporation status can eliminate the double tax in this case; however, a special built-in gain tax may apply if the S corporation was a C corporation at any time during the 10 years prior to the sale.
- On liquidation: If an S corporation decides to liquidate, shareholders avoid double taxation because the gains the corporation makes on the distribution of assets will increase the shareholder's stock basis in the S corporation. This "step up" in basis offsets the taxable gain the shareholder would otherwise realize on the receipt of the assets in exchange for the stock in liquidation.

No self-employment tax on earnings. Unlike partners and sole proprietors, S corporation shareholders are not required to include pass-through earnings from the business in income subject to self-employment taxes.

Pass-through savings. If a C corporation sells an item and transfers the proceeds to its shareholders as salary, it incurs a taxable capital gain and an ordinary deduction for the salary. The proceeds received as salary become ordinary income on which the shareholders must pay tax. The S corporation's pass-through ability lets those proceeds go to the shareholder without additional tax.

Accounting flexibility. Generally, regular C corporations must use the accrual method of accounting if gross receipts exceed $5 million. However, for tax purposes, an S corporation does not. It can elect to report taxable income under the cash receipts and disbursements method of accounting, which some businesses find gives them more flexibility in matching actual cash flow with the timing of taxable income and deductions.

Cons

Shareholder limits. An S corporation faces restrictions on the type and number of shareholders it can include, and on its ability to issue multiple classes of stock. If a violation of these rules inadvertently triggers a loss of S corporation status, the owners may see a large unanticipated tax cost. So companies that choose S corporation status must be careful to maintain their qualifications. For example, if the owners of an S corporation pay dividends to shareholders that are not proportionate to their ownership interests, the IRS may argue that there are effectively multiple classes of stock and terminate S corporation status, leading to double taxation on all the dividends paid.

Personal responsibility. In an S corporation the shareholders, rather than the corporation, are individually responsible for paying quarterly estimated income taxes on the corporation's taxable income. Many business owners do not like this additional burden, particularly if the corporation does business in multiple states. However, the availability of state composite income tax returns can ease the shareholders' individual state tax filing requirements.

Costs to owner-employees. Under an S corporation, employees of an S corporation who own greater than two percent of the stock may have to pay personal tax on the value of certain fringe benefits.

Financial transparency. This is either a pro or a con depending upon the owner's perspective. Since shareholders must report the S corporation's income on their personal income tax returns, they will have a sense of the corporation's level of earnings. The senior controlling shareholder may or may not want that information to be widely known.

Pros and cons of a C corporation

Pros

Flexibility in selecting a fiscal year end other than December 31

Maximum corporate tax rate is lower than maximum individual income tax rate

Cons

Double taxation…

- Of earnings: A C corporation pays corporate income tax on each dollar of profit and when the dollar of profit is paid to the owners as a dividend, and the owner pays income tax on the dividend a second time. If closely held business owners try to avoid double tax by paying inflated salaries to employee owners instead, the IRS may recharacterize a portion of the salary as a dividend and deny the salary deduction for the corporation under the rules for unreasonable compensation.
- Of gains from sale: The C corporation double tax also applies to corporate assets sold for a gain. The corporation pays tax on the gain on the sale of the corporate asset, and when the after-corporate tax cash is distributed to the owners, they pay tax on it again.

Inability to retain earnings. Closely held owners cannot simply retain the earnings in the company to indefinitely defer paying the dividend tax, because of the IRS's accumulated earnings tax. Under these rules, C corporations cannot accumulate cash in the business unless there is a valid business reason. The IRS can recharacterize the retained earnings as dividends and charge the corporation a penalty tax equal to the highest marginal individual income tax rate.

This is the second volume in our Business Succession Planning series. The first volume, *The need for planning,* is available for download at http://www.deloitte.com/us/ perspectives/dges.

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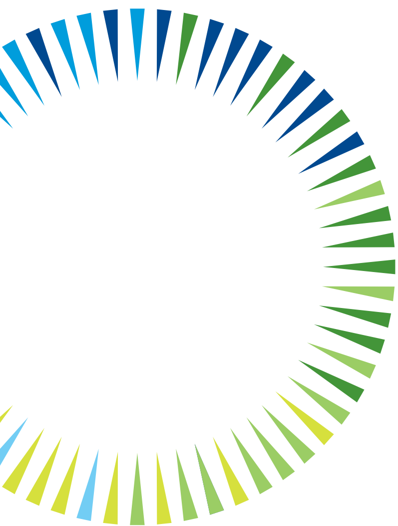

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