THE PRIVATELY HELD BUSINESS

RESOURCES

Putting the business transition team in place

Business succession planning is a complex and sensitive topic. A team approach including many professionals can be very beneficial to the business owner and can minimize both disruption to the business and internal conflicts.

- A wealth management advisor, such as your CIBC Private Wealth relationship manager, can serve as the coordinating "partner" for your path through a privately held business transition. He or she will bring in expert resources, such as those described below, as needed.
- An attorney is truly a "counselor" when it comes to business succession planning. The attorney must recommend and include the legal arrangements and vehicles that are best suited for the business and the owner's personal objectives, given the family dynamics. Attorneys may represent the business itself, the business owner and possibly even other family members, which can affect the lawyer's independent judgment. The same conflict of interest rules apply in this situation as they do in all other attorney representation matters. The attorney must exercise caution and clearly disclose and document all potential conflicts of interest as well as state clearly whom they represent and whom they don't.
- A business accountant has both specialized tax reporting expertise and detailed knowledge of the financial system of the business, especially its cash flows, history and profitability. An accountant typically communicates with the business owner on a regular basis and, because of this ongoing contact, will often have invaluable insights in identifying possible difficulties and conflicts.
- Because solutions to liquidity concerns often include varying types of life insurance, an insurance professional who is well versed in estate planning and business succession can be an asset to the estate plan. Consultation with multiple insurance professionals can ensure that any life insurance program is appropriate for the business owner and is competitively priced.
- A banker who is familiar with the financial health of the business and its owners or who has extended credit to the business in the past may ease the transition from a financial and business operations standpoint. A banker participating in the business succession process can advise the business owner on ways to maintain the business's lines of credit in order to assuage the transition period and minimize the likelihood of disturbing business during a shift in control.
- A trust officer, as a representative of a corporate trustee, can provide continuity and interim control of the business during a transition period if the next generation of owners and managers is not yet ready to assume control. Sophisticated trust institutions have substantial experience in dealing with privately held businesses and assisting in business transitions.
- Valuation of the business, whether it is sold or transferred, is an essential part of the succession plan. Appraisers with a high level of expertise and experience are better able to value the business accurately and defend their valuation in the event the valuation is challenged. Sometimes it is not advisable for an accountant (even if qualified) to serve as the appraiser. A neutral appraiser, with no apparent ties to the business owner or the business, may provide the most unassailable business appraisal if there is a potential for conflict among the family members who are unhappy with the succession plan, or if there are questionable tax positions that could be challenged.
- A family communications consultant can bring additional expertise to the business succession process. This consultant may provide expertise about business management and operation, financial analysis and counseling skills, and is particularly useful in very complex succession plans. The most effective business consultants have specialized training in family business dynamics, including family relations, and are able to facilitate communication among the family members to achieve solutions that are best for both the business and the family.

The consultant can overcome or avoid ethical conflicts that may affect other advisors on the team. Including the family members in the selection of the family communications consultant increases the likelihood that his or her advice will be respected and implemented.

- There is a large psychological component in a privately held business transition, both for the retiring business owner and his or her family. Consequently, a psychologist may be helpful for sorting out family dynamics. Owners may have difficulty letting go of the business they have worked so hard to build and also trouble facing their own mortality. The family and children of the business owner may likewise have trouble accepting their parents' mortality and the pressure they feel to keep the business growing and prospering. A trained professional who has experience dealing with these difficult subjects can help all parties remain rational and focused during the transition period.

Source: Adapted from "Transferring the Family Business to Younger Generations," Crady, Jewett & McCulley LLP. Used with permission.

Tax implications of the sale of a business

Q&A with Crawford Moorefield, J.D.

Ready, set, sell. When it comes to taxes, though, it's not that simple. The tax implications for the sale of your business require some very careful deliberation and planning. CIBC Private Wealth talked with Crawford Moorefield, J.D., a partner with Spencer Fane LLP in Houston, Texas, and an expert on taxation and structuring complex business transactions for corporations, partnerships, limited liability companies and other business entities. Here's what you need to know about how the type of entity and type of transaction can affect your tax outcome, whether you sell within or outside the family.

Q. Let's start with the initial tax considerations for the sale of a privately held business—what should be top-of-mind for the seller?

Selling your business is a major transition event, and the best advice to any potential seller is to plan for it well in advance. When you get to the point of being ready to sell, keep in mind that value and price are important, but deal structure perhaps more so—especially when it comes to the tax implications.

Q. Give us an overview of the tax implications with different types of business structures and the types of sales.

If you operate under one of what's called the "pass-through" entities—partnership, limited liability company (LLC) or S-corporation—you will have more flexibility negotiating the business's sale. With a C-corporation, there is no "pass-through" taxation, and you may find yourself subject to taxes at both the corporate and shareholder level if the C-corporation's assets, rather than its stock, are sold. It is important to note that the Tax Cut and Jobs Act of 2017 reduced the federal income tax rate on corporations to 21% from 35%. As for stock sale vs. asset sale, there are pros and cons with each. As the seller, you may prefer a stock sale so that you can get long-term capital gains treatment on the sale. For the buyer in a stock sale, there is no step-up in the basis of the business's assets, so the potential buyer may offer you less for a stock transaction than with an asset sale. A stock sale is generally considered an easier transaction because each asset and liability doesn't have to be valued. With an asset sale, each asset and liability must have a separate valuation and conveyance. I ask sellers to imagine traveling and having to carry every single item—it's much easier to pack it all into a suitcase and complete your "trip" that way. Buyers will probably want an asset sale if they believe there are unknown and contingent liabilities of the business. Today, there are concerns about environmental issues—for example, a manufacturing company that's been on a piece of land a long time. We often don't know what may have gone into the ground for years, or who was on the land before the current business.

There's a provision in tax law that allows a special election—Section 338(h)(10)—under which a stock sale can be considered an asset sale for tax purposes. This rule applies when a C-corporation sells the stock of a consolidated subsidiary to a corporation, or the shareholders of an S-corporation sell all of its stock to a corporation. In this case, the buyer does get a step-up in the basis of assets acquired even though he or she technically acquired stock. In each case, the gain from the deemed asset sale flows through to either a consolidated group or the S-corporation shareholders, increasing the basis in the stock of the corporation and reducing any gain on the deemed liquidation to get the proceeds into the seller's hand. Similar rules, under Section 336, apply when the purchaser is not a corporation. As the seller, it's as if you're selling individual assets of the S-corporation, so some of the gain can be treated as ordinary income. Also, as with a regular asset sale, the deemed purchase price must be allocated among the target's assets.

Q. Is there any way to avoid a C-corporation's "double tax" situation in an asset sale?

Yes, by asking the buyer to pay one amount for the corporate stock and pay other amounts directly to you as the owner of the corporation for such things as consulting, a noncompete clause, property rental, intellectual property licenses and personal goodwill. The buyer can deduct the payments immediately for some things and amortize others over 15 years. But these direct payments to you will usually be subject to ordinary income tax, rather than the capital gain rates available on sale of your stock. Valuing personal goodwill is tricky, and the IRS can challenge it, so it needs to be handled by a very competent lawyer or advisor who knows the case law. You will need a very solid appraisal as well.

Q. Because many family businesses may be sold into succeeding generations, is an installment sale a good option so that younger family members can spread out their purchase outlay?

This is very often the case with a family business, and it allows you, the seller, to defer the taxes on the gain until you actually receive those future payments. The IRS *does* allow you to opt out of the typical installment sale tax treatment and pay all of the tax at the time of the transaction, which could be of benefit if you believe capital gain rates will increase in the future. Of course, every seller, whether a family patriarch or matriarch or not, has to take the risk that the buyers—even their own children or grandchildren—may not be successful with the business in the future, putting future payments at risk.

Q. The federal tax situation for a business sale is complicated enough—what do we need to know about state and local tax issues?

It's true—there can be a state and local income tax burden for the seller; it depends on whether the transaction is structured as an asset sale or a stock sale. With an asset sale, tax may be owed in every state where the company has assets, sales or payroll. In addition, not all states provide for long-term capital gains taxes, so a gain that would qualify under federal laws may be subject to ordinary state tax rates. One bright spot: If your primary residency is in a state without income tax, you won't pay state tax on a stock sale, regardless of where your business operates.

Q. Final thoughts in this overview of taxes on the sale of a family business?

A family who wants to move the business down through generations needs to consider many elements of estate planning *before* the sale of the business. It's usually less efficient to move after-tax proceeds from the sale into trusts for children or grandchildren. There are quite a few tax-effective estate planning techniques that can be used when considering sale of the family business, but it's very important that your wealth manager work with you on this well in advance of the sale.

Finally, tax implications for the sale of a business are dependent on many complex variables. If your eyes start glazing over when you read about deal structures such as "reverse subsidiary merger" or "deemed transaction Section 338(h)(10) election" or a "horizontal double dummy tax-free reorganization," know that these are the situations that keep tax lawyers on their game and on top of the ever-changing tax rules. As a successful business owner who is now considering selling, you don't have to know all the ins and outs of the tax laws, but you do need to be prepared by considering all of the implications before you sign that deal.

Note: The tax information contained herein is general and for informational purposes only. CIBC Private Wealth does not provide legal or tax advice, and the information contained herein should only be used in consultation with your legal, accounting and tax advisors.

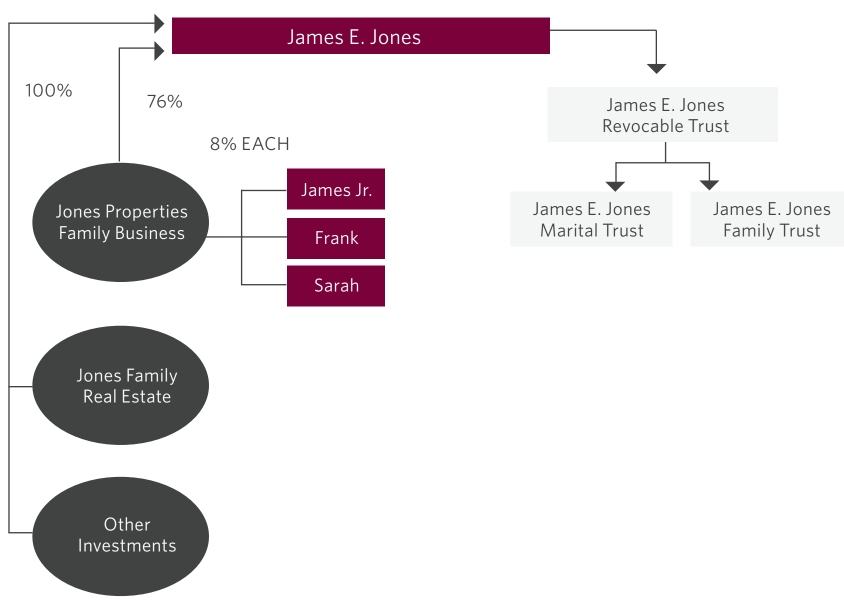
The Jones family case study

Working with clients to transition a privately held business in the context of overall estate planning can be very emotional and daunting for a variety of reasons. It is often helpful to approach the process in orderly steps, beginning with where the family is now, followed by a discussion of what they envision for the future. Having a goal in mind provides focus and allows for input by various experts. The following examples illustrate how such transition planning might work for a family with diverse needs and interests.

Case study: James and Janet Jones

- James E. Jones is an 80-year-old business owner who has been married to Janet for 50 years and has three adult children. He lives in Florida.
- He owns a 76% interest in a privately held business.
- James and Janet also own significant other assets, including real estate and liquid investment assets.
- One child, Frank, is involved in the business. Two others, James Jr. and Sarah, are not involved in the business.
- The business also has several key employees.
- James wants to transfer control of the business to Frank and provide as equally as possible for James Jr. and Sarah.
- He wants to minimize estate taxes and ensure that his wife is comfortable after his death.
- He has made gifts of 24% of the company to his children during his lifetime.
- He is interested in charitable giving as part of his family legacy plan.

Jones family current estate ownership



Analysis and observations: James Jones

During James' Lifetime

Step 1: Valuation of Business and Nonbusiness Assets
- Particularly where equalization is a concern, it is important to know the value of various family assets.

Step 2: Review Prior Planning/Gifting
- Each child has already been given an 8% interest.

Step 3: Show Disposition of Estate and Estate Tax Exposure
- Knowing what is in place currently helps clients understand the issues and articulate their wishes.

Step 4: Address Liquidity Issues to Pay Estate Taxes
- Review life insurance, if any, considering ownership and insurability:
  - Key Man, Cross Purchase, Second to Die
- Analyze availability of IRC Section Estate Tax 6166 deferral and limitations:
  - Available if business exceeds 35% of James' adjusted gross estate
- Section 303 redemption may be available for estate liquidity.
- James' estate may be able to borrow money to pay taxes.
- A well-crafted buy-sell agreement can determine the valuation calculation of the business for estate tax purposes, arrange a method for creating liquidity for payment of taxes and provide certainty for the family.

Step 5: Plan for Control and Equalization
- Should control be transferred to Frank before or after Janet's death?
  - Does control also mean ownership, or will James Jr. and Sarah retain an interest in the company?
  - If so, how should voting control be arranged and, if trusts, will the fiduciaries have voting power/control (e.g., voting trusts)?
  - Should there be a recapitalization to segregate voting control and to create different classes of stock—voting and nonvoting, common and preferred?
- What does the buy-sell agreement provide and when does it take effect?
  - At James' death? At Janet's death? At death of survivor? At other times?
  - What happens in the case of sale, death, retirement, disability or divorce?
  - How will the buyout be funded?
  - How will valuation be determined?
  - Can the company obtain insurance to do a redemption at the survivor's death to provide liquidity for estate taxes?
- Is there an employment agreement in place for Frank?
- What happens if Frank predeceases James and Janet?
- How can "equalization" be achieved?
  - Insurance
  - Equalization under wills
  - Real estate and other assets
  - Corporate reorganization to accommodate different needs/interests and create additional entities

Step 6: Begin Planning for Estate Tax Minimization or Freeze
- Current transfers can remove appreciation from the estate, allowing assets to grow in the hands of future generations, or remove assets from the transfer tax system entirely. Valuation discount strategies can augment the power of lifetime giving.
  - Outright gift
  - Sale to grantor trust
  - Sale to child/children/trust
  - Grantor retained annuity trusts

Step 7: Address Management Issues and Key Employee Retention

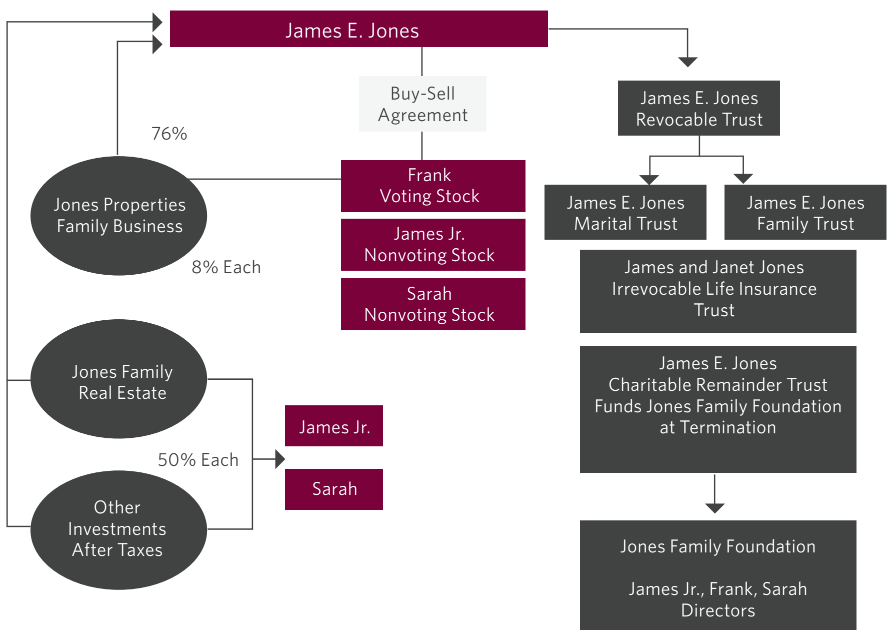
- ESOPs
- Phantom stocks
- Advisory boards
- Fringe benefits

Step 8: Consider Charitable Planning Options

- There are various charitable giving vehicles available that can be tailored to meet family philanthropic goals, including current family involvement, a need for a retained income stream to replace lost salary income and long term family legacy wishes.
  - Private foundation
  - Donor-advised fund
  - Charitable remainder trust
  - Charitable lead trust

Step 9: Putting It All Together

- The final step in any planning is to make sure that it matches the picture envisioned by the client.



Each family's story is different, and the course of the process will vary. CIBC Private Wealth has experience in navigating the development of a transition plan, so we can help avoid conflict now and in the future.

Questions to ask before hiring a business consultant

Seven issues that you must be sure to discuss

Privately held businesses are a driving force in the American economy. They range from your neighborhood dry cleaner to enormous conglomerates. Owners of privately held businesses not only have to contend with the maintenance and growth of the business, but also they must manage the element of "family" in their operations, which introduces added complexity to the issues all businesses face—including, but not limited to, governance, growth, succession and consideration of sale.

Many families turn to consultants to help them navigate the various complexities inherent in their businesses and families. This engagement is often precipitated by an event, such as the death of a leading family member, an impasse among family leaders with respect to the direction of the business, or a change in business environment. However, many families also proactively recognize that a consultant can help them anticipate certain eventualities and plan for them in advance, so that the business, and the family, may be less disrupted.

Of course, every family and business is unique, so just as issues may range from what are commonly called "soft" or "human," such as communication, to the more technical, such as business governance and structure, there are consultants with specialties in all of these areas. Therefore, it's important that the family find the right consultant for its needs once those needs have been identified. Below are some questions and issues to consider.

Scope of engagement/fees

What will be the scope of the engagement for the business consultant, and how will the fee be structured?

As in all matters, transparency is key. It will ease the process and facilitate a more open dialogue when it's clear how the time spent with your family and your other advisors in face-to-face meetings and other communications will be billed. The same goes for the preparation of material. Again, this will depend on what the consultant is being hired to help accomplish. Some consultants charge a flat fee for the initial discovery process and then move to a monthly retainer. Others will charge a flat fee for a discrete project, while some may charge by the hour. It's important to ask, as it varies depending upon assignment and consultant.

Outlining the scope of the engagement is essential to set forth clear expectations for all parties. Not all situations will have a definable time frame, but some may. If your family is seeking help in developing a succession plan, for example, will the engagement end once the plan is formalized, or will the consultant stay on for some period of time to see the transition through?

Similarly, if the consultant is hired to review the current structure of the business, will he or she be responsible for overseeing the implementation of his or her recommendations if accepted, or will the engagement end on receipt of the recommendations? Will the consultant create an educational program for the next generation on financial literacy? Or, will the consultant host a multi-day retreat for the family to address communication issues and thereafter be "on call" for a status check or as future issues emerge? Naturally, scope and fees are interrelated, so it's important to set forth a clear understanding of both before moving forward.

Family dynamics

What's the consultant's approach to family dynamics?

Today, it's entirely possible that three, even four, generations are trying to figure out how to coexist peacefully in the workplace—from the silent generation's insistence on daily desk time to the Millennials' comfort with working from a mobile device in a coffee shop at 7 p.m. It's hard enough in any company, but the challenges can run even deeper for a family business. Given the potential impact of family dynamics on the success or failure of a business, the business owner will want to know the consultant's experience and approach to identifying dynamics that will impact the business and the family. Once identified, what's the consultant's suggested method of addressing and resolving the challenges created by the dynamics so that the family and the business may thrive?

Transition or sell

What's the consultant's experience with helping determine whether to transition within the family or sell to a third party?

Founders of privately held businesses inevitably come to the proverbial fork in the road: "What next?" Retire and pass the business to the children? Or, acknowledge that the children are neither equipped nor interested in sustaining the business? Stay on in a limited capacity? Sell to a third party? The best answer to "What next?" is usually thoughtful, long-term planning to address the many issues of business succession. It's not easy, nor do business owners always easily embrace consideration of these issues.

For this reason, this question is critical to ask of a consultant: Who should be able to lay out his or her methodology for helping to guide the planning and decision-making process? Asking the consultant for case studies or client references can be particularly useful as the consultant will likely reveal his or her approach and expertise.

Succession

What's the consultant's approach to succession?

If the choice is to transition the business within the family, you will want to know how the consultant approaches this process and what his or her experiences with the dynamic elements of it are and, importantly, how he or she incorporates education of the next generation into this process.

How would the consultant help you, as an owner, to navigate this transition successfully? If accomplished properly, it's probably the most important attribute of a successful, multi-generational family business. Again, asking for case studies and methodologies should be useful in answering this question.

Sale of business

How would the consultant approach a sale of the business?

If the decision has been made to sell, what's the consultant's experience in this process? This will typically include work with outside advisors, such as valuation experts, bankers, accountants and estate planning attorneys, to name a few. Not all consultants will actively participate in the sale, but the owner will want to know about the consultant's familiarity with the necessary steps and process and understand how and where the consultant can add value.

Wealth

What's the consultant's approach to handling the impact of wealth generated by the business on the family?

Regardless of the decision to keep or sell the business, a successful privately held business is capable of creating and sustaining significant wealth for families. Therefore, a big part of the dynamics of families in business together is that family members, collectively and individually, are dealing with the wealth that the business creates. This wealth can present many possibilities for the family and, indeed, many are able to identify and sustain their shared and individual values through education, philanthropy and other business endeavors. Often, however, the wealth can create challenges for the family.

Some may be logistical and organizational and are best addressed by the creation of a family office, while other challenges may stem from the family's differences in adaptation to the wealth. For a family, and its business, to thrive, addressing the issue of family wealth created by the business, and how the members of the family relate to it individually and collectively, is essential. While there are many approaches to the issue of family wealth created by a business, a consultant should have a sensitivity to the effects of this wealth on the family members and a suggested approach to address it.

Working with others

What's the consultant's approach to working with and engaging other advisors?

Finally, a privately held business and all of the issues that arise both personally and in the context of the business will necessitate the input of many advisors and specialists. As was referenced earlier, estate planning plays an enormous role in the succession or sale of any family business and goes hand in hand with valuation consultants and accountants and other specialists.

The consultant, when selected, should be an integral part of this advisory team. ■