Transferring Closely Held Company Equity

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To a Key Employee—Part II of II

In this second part, the author provides readers an illustration of the decision-making and allocation issues. These include issuing options, phantom stock, and converting the existing entity.

Read Part I here.

The Alpha Closely Held Company Equity Allocation Process

Getting back to our Alpha illustrative example, let's keep the fact set simple. Let's assume that Fred and Ed agreed that they would jointly retain a valuation specialist to value the Alpha total equity.

The analyst recommended that the business valuation be based on the fair value standard of value and the value in continued use premise of value. The fair value standard of value assumes that the closely held company will be sold in its entirety between a hypothetical willing buyer and hypothetical willing seller. Fair value also assumes that the value does not include a unique purchase price premium that would be paid by a specific synergistic buyer. And, fair value assumes that all equity interests are valued on a *pro rata* business enterprise basis. That means that no valuation premiums or discounts (e.g., a discount for lack of control or lack of marketability) will be applied to the equity interest transferred to the key employees.

Finally, the recommended valuation premise assumes that Alpha would be sold as a going-concern business enterprise—and not based on an orderly (or forced) sale of the company assets.

Let's assume that the analyst applied generally accepted business valuation approaches and methods. And, the analyst concluded that the current fair value of 100 percent of the Alpha equity is $10 million. Now, the question remains, how much of this $10 million total equity value will be transferred to Ed?

To simplify our example, let's assume that Fred and Ed can amicably negotiate the equity allocation issue. While they each had legal counsel sit in on some of the discussions, Fred and Ed ultimately negotiated a 30 percent equity allocation. That is, after the equity transfer, Fred agrees that Ed will own 30 percent of the Alpha equity. Now, the final—and perhaps most difficult—question is, how will this equity transfer be effectuated? That is, what will be the structure of the equity transfer transaction?

In our example, Ed wants to own a direct equity interest in Alpha. That is, he does not want a contractual right or a quasi-equity interest. And, Ed does not have a lot of cash on hand to either (1) pay for an equity purchase or (2) pay the income tax expense related to an equity grant. Also, Ed does not want to assume a large amount of debt to finance the equity purchase.

These transactional constraints are extremely common regarding an equity transfer to a key employee. Let's explore what options are available to Fred and Ed, given these common transactional constraints.

Consideration of the Equity Transfer Alternative Structures

Many structuring alternatives—and the corresponding risks—should be considered when evaluating the equity transfer transaction, including the following:

- Having the key employee directly purchase the equity interest
- Granting the equity interest to the key employee
- Creating a phantom stock plan for the key employee
- Issuing stock appreciation rights to the key employee
- Converting into a partnership and granting the key employee a capital interest
- Converting into a partnership and granting the key employee a profits interest

The following discussion summarizes each of these equity transfer alternative structures.

Having the Key Employee Directly Purchase the Equity Interest

A common way to bring in an additional owner is through the direct purchase of the closely held company equity. The equity units can be purchased from an existing equity owner; or the company may issue additional equity interests. The employer company will typically engage an analyst to perform a business valuation to determine the value of the closely held company equity.

If the equity interests are purchased from an existing owner, the selling equity owner recognizes gain or loss to the extent that the sale proceeds differ from the owner's tax basis in the transferred equity.

If the equity purchase is financed by the key employee with a loan, then the new equity owner can deduct the interest expense. Of course, the key employee should allocate the interest expense deduction between business interest and investment interest. The equity acquisition loan may be financed either through a third party or by the selling equity owner. Financing the equity acquisition loan through a third party has the advantage of transferring the financing risk away from the selling equity owner.

In our illustrative example, let's assume that Ed does not have the financial resources to directly purchase the 30 percent equity interest in Alpha. Let's further assume that Fred is reluctant to finance the equity purchase. Accordingly, in our example, this equity transfer alternative structure may be eliminated from consideration.

Granting the Equity Interest to the Key Employee

Another alternative to add an equity holder to the closely held company is to grant equity units to the key employee. In this alternative structure, the new equity holder would recognize taxable income at the grant date in the amount of the fair market value of the new equity units. Depending on the equity value, this alternative could result in a sizable income tax lability. The distribution of cash to the new equity holder can mitigate the employee's income tax payment. However, the cash distributions paid to equity holders must remain proportionate to ownership in an S corporation. This means that any additional cash distributions may need to be made to all the existing company equity holders. Accordingly, the cash availability of the closely held company may preclude this equity transfer alternative.

In our example, let's assume that both Fred and Ed want the equity transfer transaction structure to be as tax-neutral as possible. Therefore, this equity transfer alternative structure is not appropriate.

Creating a Phantom Stock Plan for the Key Employee

Under a phantom stock plan, the employer company awards bonuses to the key employee by providing "phantom" equity units. The employer company promises to make the key employee a cash bonus payment in the future, based (1) on the number of phantom units granted and (2) on either the value of units of the company equity or the increase in the value of the units over a specified time period.

The key employee pays no income tax when these phantom equity units are granted. However, any payments on the phantom units are treated as compensation income to the key employee.

Such a phantom stock plan has many positive aspects. However, in our illustrative example, some of the negative aspects that would result from a decision to use phantom equity units include the following: (1) the key employee would not receive an actual ownership in the Alpha company and (2) the compensation would be taxed as ordinary income—versus as a capital gain treatment for a true equity ownership interest.

In this illustrative example, Ed wants a true equity ownership interest in Alpha. Accordingly, this equity transfer alternative structure may be eliminated from consideration.

Issuing Stock Appreciation Rights to the Key Employee

A stock appreciation right (SAR) allows the key employee to participate in the growth of the equity value. This is generally accomplished by the employer company paying the employee cash for the increase in the value of a certain number of units of the company equity either (1) over a predetermined period or (2) at the time the employee exercises his or her rights under the plan. The payment to the key employee will equal (1) the units current value less (2) the unit's value at the time of the grant. An SAR is somewhat similar to a phantom stock plan, except that the phantom stock plan usually takes into account stock splits and stock dividends. In contrast, under a phantom stock plan, the payment period is usually fixed.

Under an SAR plan, a bonus payment may be made in actual units of the employer company equity. However, as with phantom stock, the initial grant of the SAR does not convey actual equity ownership. We recall that an actual equity ownership in Alpha is important to Ed.

In addition, the company equity units must be valued more frequently when the employer company issues a SAR. This periodic business valuation procedure may create a significant additional expense for a smaller closely held company.

As was the case with the phantom stock alternative, Ed's desire for true equity ownership eliminates this equity transfer alternative from further consideration. However, for many closely held companies, an SAR or phantom stock plan can be an effective procedure to offer incentive-based compensation for the key employee.

Liquidating the S Corporation and Reforming it as a Partnership

With the equity transfer alternative structures that would retain the S corporation tax status effectively eliminated, our illustrative parties could evaluate converting Alpha from an S corporation to a partnership. Liquidating the Alpha S corporation tax status would result in a taxable gain for Fred. This equity transfer alternative would also potentially result in a higher tax liability for Fred on the pass-through income. Also, as active members of the Alpha LLC, both Fred and Ed would now have to pay self-employment tax on any guaranteed payments—plus on their distributed share of the Alpha partnership income.

However, in our illustrative example, the increased flexibility of a partnership structure may appeal to both Fred and Ed. Any future cash distributions would no longer be required to be paid on a *pro rata* basis. In addition, the partnership cash distributions would be tax-free to the

extent of the partner's tax basis.

Purchasing Equity Units in the New Alpha Partnership

Partnership equity units can be purchased either (1) from an existing partner or (2) directly from the partnership—in exchange for a capital contribution.

As described previously, the direct purchase of equity interests was not an attractive alternative transfer structure for Ed.

Granting a Capital Interest in the New Alpha Partnership

Granting Ed a capital interest in the new Alpha partnership would create a taxable transaction to Ed (see Regulation 1.721-1(b)(1)). In this alternative structure, Ed would be required to recognize income in the amount of the fair market value of the Alpha partnership units that he would receive. Based on our illustrative fact set, this income amount would be approximately three million dollars. Understandably, both Ed and Fred would like to avoid this income recognition outcome.

Granting a Future Profits Interest in the New Alpha Partnership

With a future profits interest, Ed would share in the prospective growth and income of the new Alpha partnership. According to Internal Revenue Service Revenue Procedures 93-27 and 2001-43, the receipt of a pure profits interest by a service provider is not a taxable event. This income tax result will occur provided that the following three criteria are met:

1. The partnership and the service provider treat the service provider as the owner of the partnership interest from the date of its grant, and the service provider takes into account the distributive share of the partnership income, gain, loss, deduction, and credit associated with that ownership interest in computing the service provider's income tax liability for the entire period during which the service provider has the ownership interest.
2. Upon the grant of the profits interest or at the time that the profits interest becomes substantially vested, neither the partnership nor any of the partners deduct any amount (as wages, compensation, or otherwise) for the fair market value of the ownership interest.
3. All of the other conditions of Revenue Procedure 93-27 are satisfied:
    - The profits interest does not relate to a substantially certain and predictable stream of income from the partnership assets.
    - The partner does not dispose of the profits interest within two years of its receipt.
    - The profits interest is not a limited partnership interest in a publicly traded partnership.

If all these three criteria are met, then Revenue Procedure 2001-43 states that an Internal Revenue Code Section 93(b) election is unnecessary.

After the above-described negotiation between the two principal parties, let’s assume that Fred and Ed agree to a 30 percent ownership interest in the Alpha partnership future profits, with preferential rights to Ed in the net proceeds from any future liquidation of Alpha.

Converting the Alpha LLC into a Partnership

Under the check-the-box regulations, if an eligible entity that has elected to be treated as an association taxed as a corporation then makes an election on Internal Revenue Service Form 9932, *Entity Classification Election*, to change its classification to that of a partnership, Regulations 301.7701-3(g)(1)(ii) and (iii) expressly provide that the “assets-up” treatment applies.

Under the so-called assets-up approach, first the corporation will be treated as if it was liquidating by distributing all of its assets, subject to its liabilities, to its shareholders. Second, the next procedure would be to transfer the Alpha assets that the shareholders received from the corporation to the partnership (or to the LLC taxed as a partnership) in exchange for the partnership interest.

The liquidation of all the Alpha assets is treated as if the transferred assets were sold at fair market value. Any gain or loss would be computed by subtracting the adjusted tax basis from the fair market value amount. In the case of any tangible assets with a fair market value that exceeds the adjusted tax basis, the depreciation recapture rules would apply.

In each equity transfer structure, all of the parties should consider the following question: is the income tax liability incurred a worthwhile cost for the existing equity holders in exchange for retaining the key employee? The answer to this question will depend on the facts and circumstances of every individual business.

The immediate cash expenditure for the income tax payment will be substantial in our illustrative example. However, the existing equity holder, Fred, will then have a higher tax basis and capital account in the new partnership. The higher tax basis will result in less gain for Fred in the event of a sale of the new Alpha partnership in the future.

Corporate Goodwill Versus Personal Goodwill

A particularly challenging issue regarding a corporate conversion and liquidation is the distinction between the company’s corporate goodwill and the selling equity holder’s personal goodwill. As an architectural professional services company, the Alpha LLC owns a certain amount of working capital assets and tangible assets. However, these assets are not necessarily the primary driver of the business value in a professional services firm. It should be recognized that intangible value goodwill is also an important (albeit intangible) asset of the successful professional services company.

The facts in our illustrative example indicate that any goodwill in the Alpha LLC liquidation may not be corporate or institutional goodwill—that is, an asset of the Alpha business enterprise. For a smaller closely held company, goodwill is an asset of the business enterprise (1) when

the owners are not active participants in the business but are merely passive investors and (2) when none of the equity holders are critical to the company's continued success.

In contrast, personal (or professional) goodwill is an asset of the equity holders when it is their reputation, expertise, and knowledge that drives the closely held company's overall profit and value. If an equity holder's departure would diminish the company value and its ability to continue to produce profits, then the goodwill should be personal goodwill—and not an intangible asset of the business enterprise. In addition, recent judicial decisions have found that, in the absence of a binding noncompete agreement, personal goodwill may exist separately from any corporate or institutional goodwill (see, for example, *Bross Trucking, Inc.*, T.C. Memo. 2014-107).

In our illustrative example, we assume that Fred does not have a noncompete agreement with Alpha. As the Alpha sole equity holder and CEO, Fred was not a passive investor. And, we assume that the Alpha long-term success and reputation were largely due to his vision and efforts. Fred's departure would have been catastrophic to Alpha, and it likely would have resulted in the complete collapse of the Alpha business enterprise.

In our illustrative example, Ed does not have either an employment agreement or a noncompete agreement with Alpha. While the presence of Ed on the Alpha staff is a competitive advantage, Ed's departure would not be catastrophic to Alpha. The Alpha clients' loyalties and their satisfaction with Alpha is largely due to the quality of the professional services they receive, and not due to the goodwill of the Alpha business entity.

In this illustrative example fact set, we can assume that the existence of personal goodwill owned by Fred reduced the gain that he recognized upon the S corporation's liquidation of Alpha.

The Alpha Equity Transfer

In our example, immediately upon the liquidation of Alpha as an S corporation, let's assume that the Alpha business reforms as a partnership. Fred would recognize a gain on his personal income tax return for the deemed sale of the Alpha working capital assets and tangible property assets. Fred will contribute these assets to the new Alpha partnership.

In our example, Ed is granted a 30 percent profits interest in the new Alpha partnership, and he does not incur any immediate income tax liability. To compensate for Fred's taxable gain on the liquidation of the Alpha S corporation, let's assume that Fred receives an additional cash distribution to alleviate that tax burden.

Summary and Conclusion

Closely held companies often face the situation where long-term, loyal employees desire to own part of the company equity. If such employees are truly key employees, then the current equity owners often have to make an accommodation to transfer an equity ownership interest to these valuable employees.

The transfer of equity ownership in a closely held company is a complicated process. It is complicated for both taxation and business reasons. Both parties involved in the equity transfer—the employer company and the key employee—should obtain professional advice. This professional advice may include tax advice, legal counsel, and business valuation services.

This discussion presented the simplified illustrative example of Alpha Architectural Associates. This example presented various equity transfer alternative structures considered by the sole equity holder, Fred Founder, and by key employee, Ed Employee. After careful consideration of numerous alternative transfer structures, Fred and Ed reached a mutually agreeable solution whereby Ed became a 30 percent equity owner in the closely held company.

In conclusion, in this discussion, the Alpha Architectural Associates illustrative example is deliberately simplified. However, the example illustrates that, with competent professional advice and with all parties negotiating in good faith and with good intentions, the current closely held company owners and the key employee can achieve the objectives of all parties through an efficiently structured transfer of equity interests.

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