

If it's not Broken, Why try to fix It?

Restructuring the thriving business - some practical considerations

By Mike Smith

Restructuring the entity form of an ongoing business can be driven by a number of factors such as liability, tax, or an attempt to create more flexibility. Whatever the motivation, careful planning is the key. In some instances, a business may restructure or recapitalize without changing business form. For example, a business that starts as a sole proprietorship might grow into a multi-employee concern with more than one investor. Understandably, business owners desire to protect their personal assets from legitimate business risks, such as the acts of their fellow-owners and employees. In such a case, entity restructuring might involve moving from a sole proprietorship form to a limited liability entity form, such as a corporation, a limited liability company, or a limited partnership.

Generally speaking, in the sole proprietorship entity form, the owner's personal assets are subject to the contract and tort liabilities of the business, and the business income, loss, and tax credits are assessed directly to the sole proprietor's personal income tax. With a limited liability company or a limited partnership, the owner's personal assets are generally shielded from the company's liability, to the extent that those assets have not been contributed to the company, but the owner is taxed similarly to a sole proprietorship, showing items of income, loss, and credit on the owner's personal return. A corporate entity shields' owners' (shareholders') personal assets from company liability, similarly to a limited liability company or limited partnership; however, unless the corporation qualifies for election as a small business corporation under the Internal Revenue Code and makes an "S" election, the corporation reports income, loss, and credits on its corporate tax return, then investors must report gain on their personal tax returns when they receive dividends or guaranteed payments (salaries) from the corporation. When a corporation makes an "S-election"; however, the shareholders report corporate income, loss and credits on their personal income tax returns, and the corporation does not generally file a separate return.

In the current economy, factors other than liability also bear on the decision to restructure a growing business. The business may need to increase capital to accommodate the requirements of a lender. The business might encounter a significant change in the size or scope of its operations, for example, in response to successful e-commerce opportunities. Investors might simply desire a more flexible form of ownership. The business might need to take on new investors in as flexible a manner as possible without running afoul of securities laws and regulations. Tax considerations are also crucial in entity selection or restructuring. Federal and state tax treatment of the entity form might make the present form less attractive than it was originally.

A case study of the need to restructure a successful business might read as follows: Suppose the owner of a business has been operating the business as a corporation for fifteen years, and the company is presently worth \$5 million. Suppose further that over the last two years, the company has substantially increased in value, partly due to the marketing efforts of two key employees. The owner desires to reward the two key employees with an ownership stake in the company, and he believes such a reward will encourage further company growth. While the owner desires to give the key employees an ownership stake, the owner does not desire to give away too much of the company, given that the owner has developed the company over the past

fifteen years. Also, giving employees common stock based on the existing value of the business could have a significant adverse tax impact on the employee-shareholders, who might have to include the fair market value of the stock as personal.

In such a situation, the company might consider restructuring its corporate form by creating two classes of stock. In that case, the owner would be issued preferred stock, with a value of \$5 million (the total fair market value of the company) while the two key employees and the owner would hold common stock. The net result is that the owner would receive the first \$5 million on the sale or liquidation of the business, and the owner and the key employees would share ratably in the value over \$5 million. In addition, since the preferred stock is worth the same amount as the total value of the company, there should generally be minimal tax to the employees upon receipt of their shares (i.e., the shares have no value on the date of the transaction). The owner would thereby receive value for his efforts in developing the company during its first fifteen years, and the key employees and the owner would be rewarded for the growth of the business after the restructuring.

The creation of two classes of stock is not always possible, particularly where the existing corporation is required to maintain only one class of stock, as is the case with the "S" corporation. In such a situation, or in situations where the parties do not desire to risk assessment of tax upon the employees' common stock due to the interpretational aspect of appraised value of the company, other forms of compensation, such as a "phantom" stock plan, might be more desirable. Under a typical phantom stock plan, the employer corporation rewards key employees in the form of hypothetical, rather than actual, shares of its stock. The hypothetical ("phantom") stock, is credited to the employees, as are all dividends and stock splits which are attributable to the phantom shares. The employees do not pay tax at the time they receive the credits, but they do pay income tax at some time in the future, when they are entitled to receive money in accordance with the plan. Because phantom stock plans and phantom stock option plans are more appropriately considered in the compensation planning context, rather than in the entity restructuring context, they are not further discussed here.

Whatever the reasons for restructuring, business owners should also give careful consideration to the method of re-structuring. Various forms of tax-free reorganization exist for most of the more commonly utilized limited liability entities. Tax, and other considerations dictate whether the reorganization takes the form of an acquisition, merger, start-up or other form. Some restructuring mechanisms have even been codified by Ohio statutes, such as the case with merging a general partnership into a limited partnership, or a limited partnership into a limited liability company.

Business owners and managers should consult their business counsel to determine whether and when to restructure their entity, and which method of restructuring is best for them.

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