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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 op-

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portunities. 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 income.

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 restructuring. 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.

STRUCTURING A BUSINESS FOR EQUITY INFUSION

Some Practical Considerations

By Dave Jackson

Raising capital is a major concern for many businesses. To increase sales, a business may need to make additions to its sales/marketing team. To expand a product line, intellectual property and manufacturing costs will increase. To develop the geographic reach of a business, new facilities and equipment are sometimes required. Such items require capital, and traditional commercial lending is getting harder to find as the economy continues its downward trend. When traditional financing is not available, or is not cost-effective, business owners sometimes consider raising needed capital by selling equity in the business to investors. This article addresses certain common organizational and tax issues that arise when positioning a business for raising investment capital in a private offering (as opposed to a public offering, which is beyond the scope of this article). The two most common business entity forms – the corporation and the limited liability company -- are considered.

To raise capital for a business, the entity generally must issue new equity to investors. Issuing new equity typically results in reducing the ownership percentage of the existing owners (to the extent they are not part of the new investor group). "Ownership" of a business involves three important and distinct aspects:

- (1) management/control;
- (2) entitlement to ordinary course distributions of cash flow; and
- (3) entitlement to liquidation event distributions.

Management/Control

Management and voting control of a business entity depends on the type of entity in question (e.g., corporation vs. limited liability company).

Corporations.

Absent other arrangements (such as a close corporation agreement), management of a corporation is vested in its board of directors. Shareholders of a corporation are entitled to elect the board of directors, but once they have done so, they generally are not entitled to participate in management decisions. In a closely-held corporation, the shareholders typically participate in management (as directors or otherwise). When stock is issued to investors, the role of the board of directors will typically become more defined. If investors do not require the right to vote for directors or on other matters upon which shareholders may be entitled to vote, the corporation can issue non-voting stock to investors, while the original owners retain all of the voting stock. Investors frequently desire to participate in management decisions, so the non-voting stock alternative is typically not available. If voting stock must be issued to investors, the original shareholders should carefully consider how much stock they need to retain in order to elect a desired number of directors. Board decisions are typically effectuated by majority vote of the entire board of directors. Depending on the amount of capital required, original owners may not be able to retain majority board representation. In such cases, they may at least be able to secure minority board representation so they can continue to participate in management decision-making. Further, agreements such as close corporation agreements and voting agreements can be employed to insure original owners have a meaningful right to participate in board decision-making.

The low-down: Voting rights can be separated from economic rights through no-voting classes of stock.

Limited Liability Companies.

Limited liability companies "LLCs" can be member-managed (managed by the owners) or manager-managed (managed by managers, who can be owners or non-owners). Voting rights among members or managers are governed in most states by an internal contract between the members called an "operating agreement."

It is common for a closely-held LLC to be member-managed, with management issues being decided by a majority vote of the members. If retention of voting power in connection with an equity offering is important, the owners might consider providing for management by managers (instead of by the members). In this manner, investors who become members will not be entitled to vote on management issues merely by virtue of owning equity in the LLC. Instead, investors may be permitted to vote for managers, who in turn manage the LLC (managers being comparable to directors in the corporate setting). The same considerations as outlined above for corporate boards of directors apply to these types of arrangements, with the important distinction that the operating agreement (rather than the

articles of organization) can reflect all such items. Although they also can be set forth in the articles of organization, doing so typically is neither required nor desirable.

The low-down: LLCs provide the most flexibility relative to voting rights. Voting rights can be completely separated from economic entitlements by making the LLC manager-managed, and by creating separate classes of units (voting and non-voting). These arrangements can be effectuated privately without changes to the organizational filings of record.

Cash Flow Entitlements

"Cash flow" of an organization typically refers to the cash received from all sources (other than owner contributions to capital) net of cash expenditures. As is the case with voting control, cash flow distributions are treated differently depending on the type of entity that is involved in the equity offering.

Corporations.

Corporations distribute excess cash flow to the shareholders in the form of dividends. Dividends are inflexible in the sense that all shareholders of a particular class must receive cash flow distributions in proportion to their stock ownership (in that particular class). If preferences as to cash flow distributions are desired, different classes of stock must be created for such purposes, which generally requires amendment to the articles of incorporation of the corporation. Importantly, if the corporation is organized as an S corporation, different classes of stock with respect to economic entitlements are not permitted.

C corporations are permitted to have different economic classes of stock, but C corporations are not treated as "flow-through" entities for tax purposes. This means that C corporations must report taxable income or loss on their corporate tax returns (and pay tax on such income, if any, at the corporate tax rate), then shareholders must pay individual income tax on any dividends received by them. S corporations, on the other hand, pass all of their taxable income through to investors, with investors reporting their respective shares of such income on the investors' tax returns. Flow-through treatment is sometimes desirable for investors (particularly if there will be tax losses that the investors may want to flow through to them). However, institutional investors and tax-exempt organizations frequently desire C corporations as the investment vehicle, because taxable income from unrelated business activities of the business operation can be suspended in the C corporation, rather than automatically passing through to the tax exempt investor.

The low down: Generally speaking, cash flow entitlements of investors follow the classes of stock of the organization. If investors desire priority cash flow distributions, they may negotiate for a preferred class of stock providing for such rights. Such priority rights can be separated from voting rights and are frequently further separated from liquidating distribution rights (see below).

Limited Liability Companies.

As is the case with S corporations, limited liability companies taxed as partnerships are pass-through entities. Thus, in a typical LLC, investors receive allocations of their respective shares of profit, losses and credits from LLC activities and report tax liabilities or benefits associated therewith on the investors' individual income tax returns. Unlike S corporations, there are no limitations on the number or types of investors who can become owners of an LLC. This feature makes LLCs much more flexible for equity investment purposes (provided that C corporation suspension of tax items is not desired).

In all cases in which flow through entities are used (LLCs or S corporations), investors will be required to report their shares of income and pay taxes thereon, even if they do not receive any distributions of cash from such entity. Distributions are generally determined by management, and investors may not be in a position to compel such distributions. Management may instead desire to retain available cash flow in reserve accounts to provide for anticipated future expenses. The potential for taxable gain without corresponding distributions of cash should be considered when employing flow through entities in this regard.

Cash flow entitlements in typical LLCs are frequently associated with ownership "units." These units are similar to shares of stock in a corporation. LLC units can be divided into separate classes, with different priorities of cash flow entitlements being assigned to the different classes of units. Such classes need not be set forth in the publicly-filed articles of organization of the LLC. Instead, they typically are included in the private operating agreement. This structure makes LLCs much more flexible and easier to use than their corporate counterparts.

The low down: LLCs offer the most flexible method of separating cash flow entitlements. Management and voting control can be completely separated from cash flow entitlements, and existing owners can reserve or transfer to investors as much cash flow as is required or desirable by issuing units of membership interest with the same or different economic entitlements as the existing owners. Such classes of units can be prioritized as to the amount, frequency and timing of cash flow distributions. There is literally no limit on how creatively an LLC can be structured in this regard. This flexibility makes the LLC the choice entity for equity transactions where cash flow distributions are a key element.

Liquidation Event Distributions

Unlike ordinary course (or "current") cash flow distributions, "liquidation event distributions" are those distributions which occur following a sale of the business and assets of the entity and the entity's liquidation. In a liquidation setting, all of the assets of the organization are sold, all of the debts are paid (including debts to owners), and the cash remaining after this process is distributed to the owners. In a sale setting, the assets (and sometimes liabilities) are transferred to a third party, and sale proceeds are distributed to the owners upon liquidation of the entity. Investors (particularly

venture capital investors) frequently look to the "end game" when considering whether or not to invest in a particular enterprise. This end game is sometimes referred to as the "exit strategy" of the investor. If a business has significant growth potential, investors may forego their entitlements to current cash flow distributions in order to participate in liquidation proceeds. Liquidation event distributions also vary depending on entity type.

Corporations.

As is the case with current cash flow distributions, distributions on liquidation of a corporation are typically in proportion to stock ownership. Investors who desire a preference with regard to liquidation proceeds must negotiate for a separate class of stock in this regard. Because liquidation preferences affect economic rights, S corporations cannot create separate classes of liquidation entitlements. Thus, if a liquidation preference is desired, a C corporation is the only option for corporate vehicles. In a typical liquidation preference, the investor class of stock will be entitled to a return of the initial capital invested, plus a return percentage. Once the return percentage is received, the other class or classes of stock may participate either ratably, or to exclusion of, the preferred class.

The low down: Liquidation preferences in C corporations remain popular where a C corporation is otherwise desirable (from a tax and management standpoint). Liquidation rights can be separated from cash flow and management rights by creating different classes of stock. Such classes of stock must be reflected in the publicly-filed articles of incorporation.

Limited Liability Companies.

Liquidation preferences in LLCs are created with respect to the units of membership interest by inclusion of appropriate preferred return and corresponding special allocation provisions in the private operating agreement, or, less frequently, in the publicly-filed articles of organization. The same flexibility considerations that are applicable to current cash flow distributions are applicable to liquidating distributions. Where an LLC is taxed as a partnership, applicable tax regulations require that liquidating distributions be in proportion to the final positive capital account balances. Careful drafting of the operating agreement's allocation provisions is required to assure compliance with these regulations.

The low down: As is the case with current cash flow entitlements, LLC's are the most flexible vehicles for structuring preferred return and liquidation preferences. Liquidation entitlements can be effectively separated from cash flow and management entitlements in the operating agreement without a public filing.

“WHAT DO YOU MEAN ‘DOUBLE TAX’?!” Or “Maybe I Should Make an S Election Now!”

By Richard Bibart

That invariably is the first question that a client will ask (often in a very loud voice) after (a) the client has told his or her tax advisor that a great offer has been received for the purchase of the business owned by the client’s corporation (which happens to be a C corporation) and inquires about the taxes that will be payable from a sale on the proposed terms; and (b) the advisor has responded that the taxes payable in connection with such a sale will be very significant because of the “double tax” that will result from the corporation’s sale of the business and its distribution of the sale proceeds to its shareholders.

To illustrate with modest and user-friendly numbers, let’s assume that corporation X has a tax basis (generally, original cost minus depreciation) for its business and assets of \$200,000, and that a prospective buyer has offered to purchase the business and assets for \$1,000,000. A sale by X of its business and assets for \$1,000,000 would result in taxable gain to X of \$800,000 (sale price minus tax basis).

Because X is a C corporation, it would be required to pay tax on that taxable gain. If the applicable corporate tax rate were 34%, the tax on \$800,000 of gain would be \$272,000, and X would be left with \$728,000 (out of the \$1,000,000 of sale proceeds) to distribute to its shareholders.

Assume that the shareholders have a tax basis of zero for their stock in X. Upon the liquidation of X and the receipt from X of the net after-tax sale proceeds of \$728,000, the shareholders would have long-term capital gain (“LTCG”) in that amount (i.e., the amount received in excess of the zero tax basis for their stock). If the current maximum LTCG tax rate of 15% applied, the resulting tax on liquidating distributions of \$728,000 would be \$109,200, leaving the shareholders with net cash of \$618,800 out of X’s sale proceeds of \$1,000,000. Accordingly, because of the “double tax” at both the corporate and shareholder levels, \$381,200 (i.e., more than 38%) of the total sale proceeds would need to be paid over to Uncle Sam.

The client feels even worse when the advisor explains that if, instead of being a C corporation, X were an S corporation or an LLC taxed as a partnership, the taxes payable to Uncle Sam would be only \$120,000 (i.e., 12% of the total sale proceeds), and would leave the shareholders with \$880,000 of net cash (more than \$260,000 greater than the results as a C corporation). The results are so different because, in general, neither an S corporation nor an LLC pays tax on its income or gains. Instead, the income and gain is “passed through” and taxed to the owners of the entity. Accordingly, the \$800,000 of the entity’s gain from the sale would be taxed only to the S corporation shareholders or LLC members, and the LTCG rate of 15% would result in tax of \$120,000 being payable. In general, with such a pass-through entity, there would not be any further gain recognition or tax obligation upon distributions of the sale proceeds by the entity (i.e., there would no “second” or “double” tax).

At that point, the client most likely will say “OK, let’s either have X make an election to become an S corporation, or let’s ‘convert’ X to an LLC.”

However, if a C corporation elects to become a S corporation, it must determine the amount by which the FMV of its assets (\$1,000,000 in our example) exceeds the tax basis of those assets (\$200,000 in our example) on the date the S election becomes effective. That excess is known as “built-in-gain” or “BIG.” If any of those assets are sold within 10 years, the gain realized from the sale, up to the amount of the BIG attributable to the assets sold, would be taxed to the corporation basically in the same manner as if it had continued to be a C corporation, and subsequent distributions of the sale proceeds generally would be taxable to the shareholders a second time in the same manner as described above.

Nor will “conversion” to an LLC help. Such a conversion would be treated as if the corporation had (a) sold its underlying assets at FMV (resulting in the same \$800,000 of taxable gain and \$272,000 tax liability as discussed above) and (b) made a net distribution to its shareholders of \$728,000 (resulting in the same shareholder-level gain of that amount and the same tax of \$109,200).

Bottom line . . . if a sale in the near term is likely, there will be no way to mitigate the burdensome results of the double tax to any significant degree. The best possible result would be to convince the buyer to pay \$1,000,000 for the stock of X (which would produce taxable gain of \$1,000,000 and a 15% tax obligation of only \$150,000 payable at the shareholder level). However, for a variety of reasons, it often is not possible to convince a buyer to purchase stock.

Planning Opportunity: Even if you do not contemplate a sale in the near-term, but a sale at some point in the future is likely, if you currently have a C corporation you may want to consider making an S corporation election now.

Even though the BIG rules would apply following the making of the S election, they would only apply to the BIG of the corporation that exists at the time the election becomes effective (\$800,000 in our example). Accordingly, the “double tax” would be avoided on any gain subsequently realized (a) from further appreciation in value of the existing business and assets above \$1,000,000, and (b) from all appreciation in value of assets acquired or purchased after becoming an S corporation. Further, if the sale does not take place until after expiration of the 10-year BIG period, no portion of any resulting gain would be subject to “double tax.”



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Murphy LLP at the conclusion of his judicial clerkship. David majored in advertising and mass communication (obtaining Bachelor's Degree) at the University of Georgia's Grady College of Journalism and Mass Communication, and he spent 3 years in the advertising industry prior to attending law school. David also served in the United States Army's engineering corpse. David lives in Blacklick, Ohio with his wife, Shirley, and their daughter Maria. He regularly engages in speaking on law and taxation topics at the Columbus Bar Association and other organizations, and he is the former chair of the Columbus Bar Association's Business Tax Committee. He is also active in his local church, and teaches on a variety of topics in that setting. David's hobbies include swimming and golf, and he is an avid history reader. Dave's direct line is: 614-628-0797 email: DSJ@cpmlaw.com

This edition of The Report was developed and written by our Business Law practice team.

Future Editions:

Summer editions of the Report will be written by our Commercial Law practice team.

Fall edition of The Report will be written by our Family Wealth Planning practice team.

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