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Tax Updates

Brittany Schutter
Director
Katz, Sapper & Miller

163(j) Business Interest Limitations

- Two tests to determine if subject to limitation
  - Gross receipts test
    - §448(c) aggregation rules apply
    - Total gross receipts in excess of $26 million
  - Tax shelter
    - More than 35% of losses during taxable year are allocable to limited partners or limited entrepreneur (does not actively participate in the management)
- Limits a taxpayer's deduction for business interest expense to sum of:
  - Business interest income
  - 30% of "Adjusted Taxable Income"
  - Floor plan financing interest expense

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163(j) – 2022 Changes

- Adjusted Taxable Income
  - Through the 2021 tax year, you added back depreciation and amortization to your taxable income
  - Beginning in 2022, depreciation and amortization expense is no longer an add-back item
  - Results in a lower adjusted taxable income

163(j) Limitation Example

	Pre-2022	2022
Taxable Income	$ 1,500,000	$1,500,000
Add-backs:		
Business Interest Expense	750,000	750,000
Depreciation Expense	10,000,000	0
Adjusted Taxable Income	$ 12,250,000	$ 2,250,000
30% Limitation	$ 3,675,000	$ 675,000
Limited Interest Deduction	0	$ 675,000
Interest Deduction Carried Forward	0	$ 75,000

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163(j) - Considerations

- Things to consider if business interest is limited due to 163(j)
  - TRAC leases
  - Electing out of bonus

- Must consider net present value of cash flow and tax impact for both situations to determine if there is a benefit

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Pass-through Entity Tax Elections (PTET)

- Applies only to pass-through entity types (S Corporation and Partnerships)
- Allows pass-through entity to pay tax at the entity level allowing for the reduction of federal taxable income flowing through to members rather than deducting tax at individual level
- Why the need for a PTE tax?
  - SALT deduction for individuals temporarily limited to an aggregate deduction of $10,000 ($5,000 for married taxpayer filing a separate return)
  - TCJA SALT cap applies to tax years beginning after December 31, 2017 and before January 1, 2026

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PTET - Considerations

- Which businesses might consider making a PTET election?
  - Businesses who have activities solely in their state of residence and the state has an elective PTET (e.g., real estate, brokerage, etc.)
  - Businesses who have multi-state activity with owners who are residents of states that do not impose an income tax (e.g., FL, TN, TX, WA)
  - Business who have multi-state activity with owners who are residents of states that allow credit for taxes paid for PTE taxes

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PTET – Considerations (cont.)

- High level PTET Election Considerations
  - A state PTET may not apply to all owners equally
  - Federal consideration of when PTE taxes need to be paid / accrued to be deductible for a tax year
  - PTE tax may not take the place of nonresident withholding or composite requirements
  - Consider when and how the election and related payments must be made
  - Consider residency of owners and the value of benefit

PTET – Benefit

- How much benefit PTETs will yield in federal tax benefits depends on:
  - The states in which the PTE does business
  - Composition of its owners (individuals, corporate)
  - Tax rates
  - Impact of a credit for taxes paid by the entity against the state personal income tax of the state in which the PTET is levied and the state of residence of the owner

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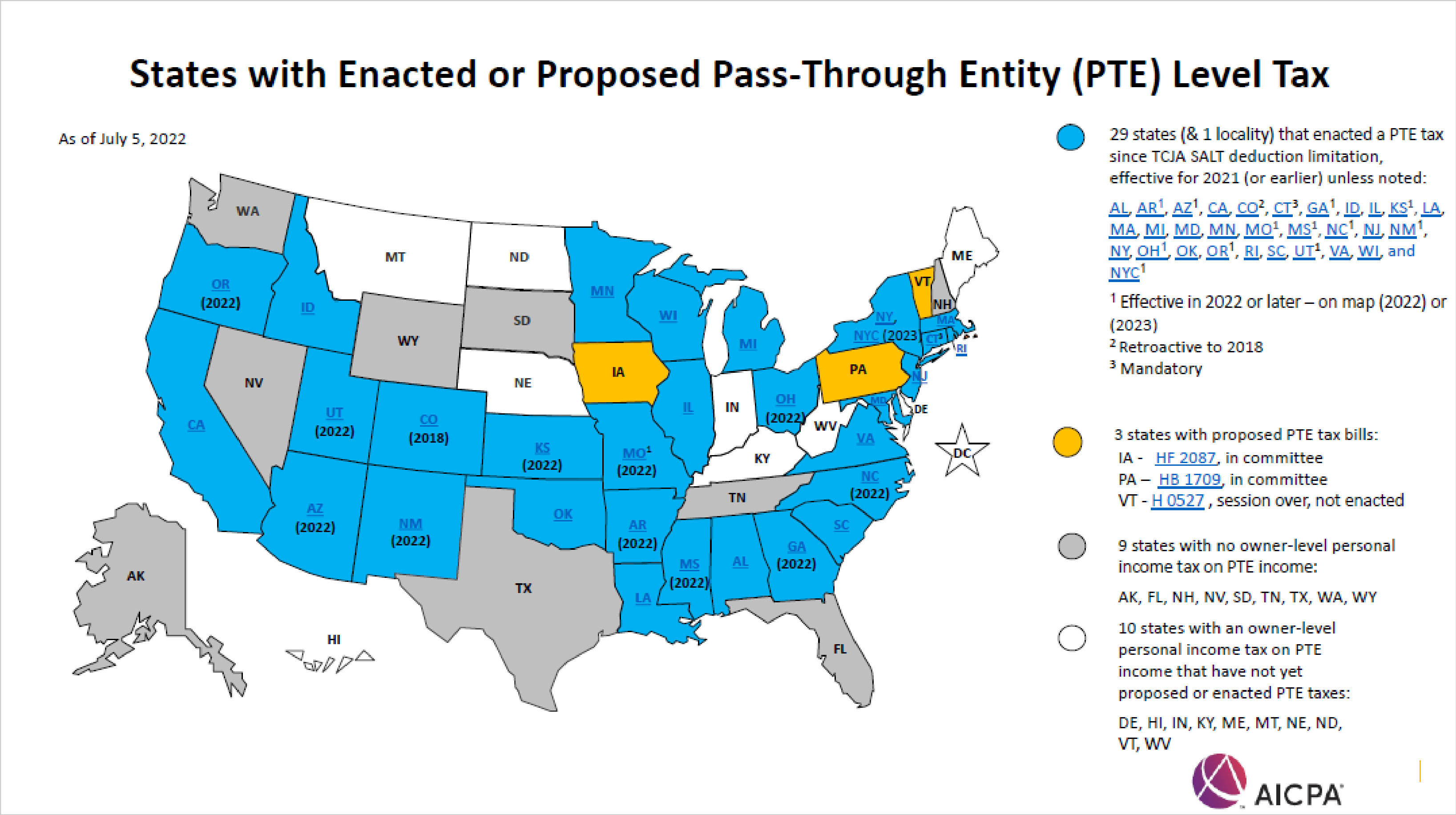
PTET – States with a PTET



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Fuel Tax Credits

- Off-highway Business Use
  - Espar heaters
  - Auxiliary power units
  - Diesel particulate filters
  - Refrigeration units
- Alternative Fuel Excise Tax Credit
  - Included natural gas and propane
  - Expired December 31, 2021

Miscellaneous Tax Updates

- Changes to deductibility of meals expense for 2021 and 2022
  - Food and beverage expenses paid to a restaurant can be 100% deducted
  - Meals & incidental expense per diems are allowed to be 100% deducted
- Bonus Depreciation
  - 2022 is currently the last year for 100% bonus depreciation
  - Phase out of bonus depreciation from 2023 to 2026
    - 2023 – 80%
    - 2024 – 60%
    - 2025 – 40%
    - 2026 – 20%
    - 2027 – 0%

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Miscellaneous Tax Updates

- Charitable Contributions
  - For taxpayers that don't itemize, they no longer have the above the line deduction of $300 for single filers and $600 for joint filers
  - For taxpayers that itemize, the deduction limitation for qualified charitable contributions goes back to 60% of adjusted gross income
  - For C Corporations, the deduction goes back to 10% of taxable income
- Annual Gift Tax Exclusion
  - Increased to $16,000 per individual in 2022
- Lifetime Gift Tax Exclusion
  - Increased to $12.06 million per taxpayer in 2022

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Business Succession Planning

Ben Lyon
Partner
Katz, Sapper & Miller

Do You Have a Succession Plan?

What road do I take?

Well, where are you going?

I don't know.

Then it doesn't matter. If you don't know where you are going, any road will get you there.

-Lewis Carroll

Alice in Wonderland

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Outline

- Succession Planning Overview
- Understand Your Options
    - "Paths" for Business Continuity
- Am I Prepared?
    - Owner Readiness Questions

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Succession Planning Overview

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What is the State of Owner Readiness?

Primary Research Conducted by EPI (Exit Planning Institute):

To poll, measure, and analyze the current market conditions that affect an owner's ability to successfully transition their business with exit planning considerations

76% of owners plan to transition over the next 10 years (representing 4.5 million businesses and over $10 trillion in wealth).

49% have no transition plan.

More than **70%** of businesses that are put on the market **do not sell.**

Only 30% of family-owned businesses transition to the second generation and only 12% survive to the third.

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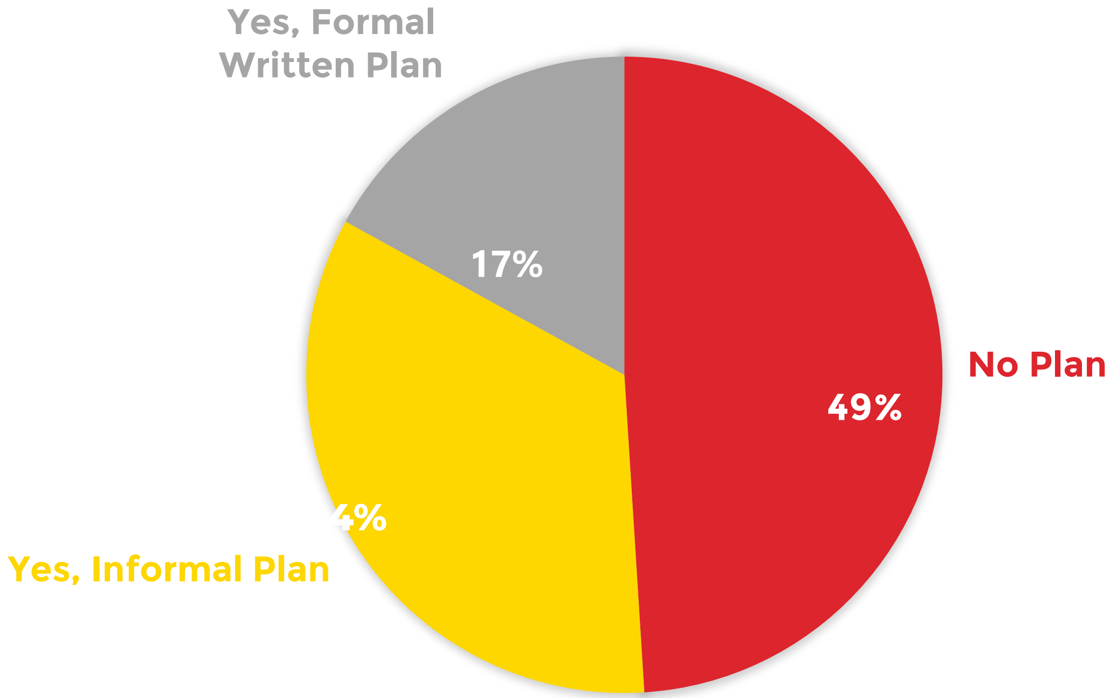
EPI State of Owner Readiness Survey

Have you prepared a transition or succession plan for your business?



2013 State of Ownership Readiness Survey, Exit Planning Institute

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Takeaways: EPI State of Owner Readiness Survey

67% of owners feel they are not familiar with all exit options

72% do not know if, or do not think, transition will impact their lifestyle

4% have a formal “Life after Business” plan

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Integrated Exit Planning

Three Legs – *The Master Plan*

Team's Organizing Principle

- Maximize the value of the business
- Ensure the owner is personally and financially prepared
- Ensure the owner has planned for the third act of their life

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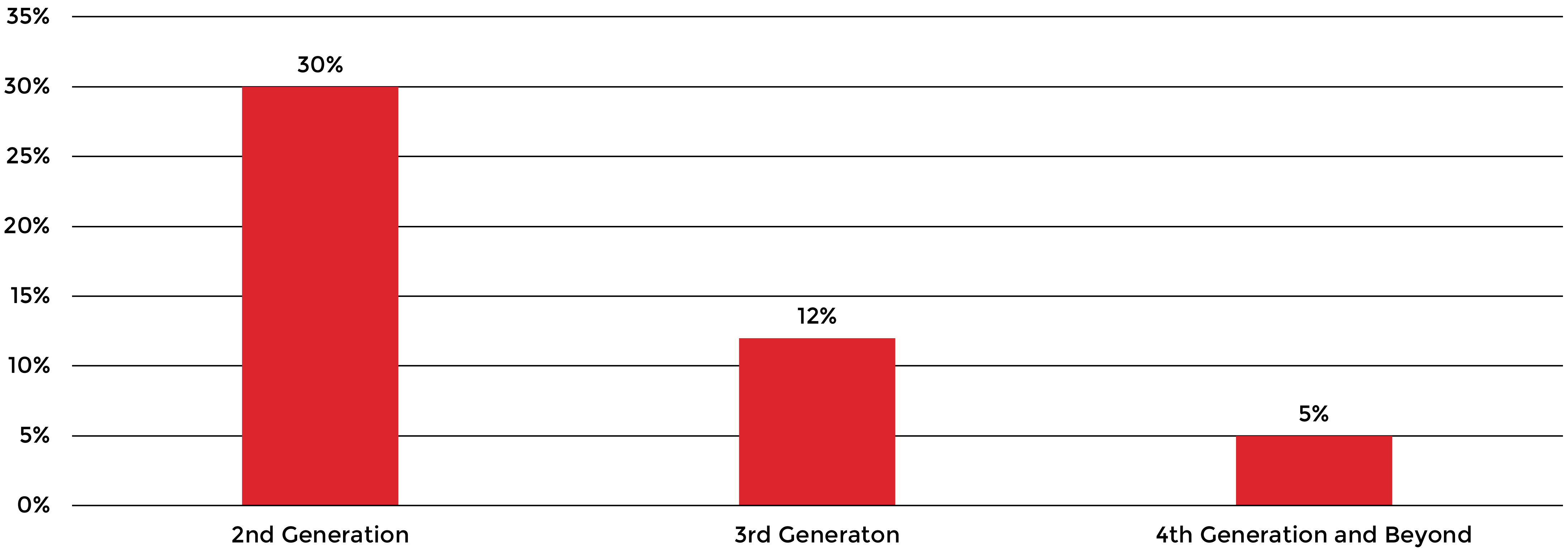
Understand Your Options

“Paths” for Business Continuity

Business Continuity to the Next Generation? Maybe!



88% of current family businesses believe the same family will continue their business in 5 years.

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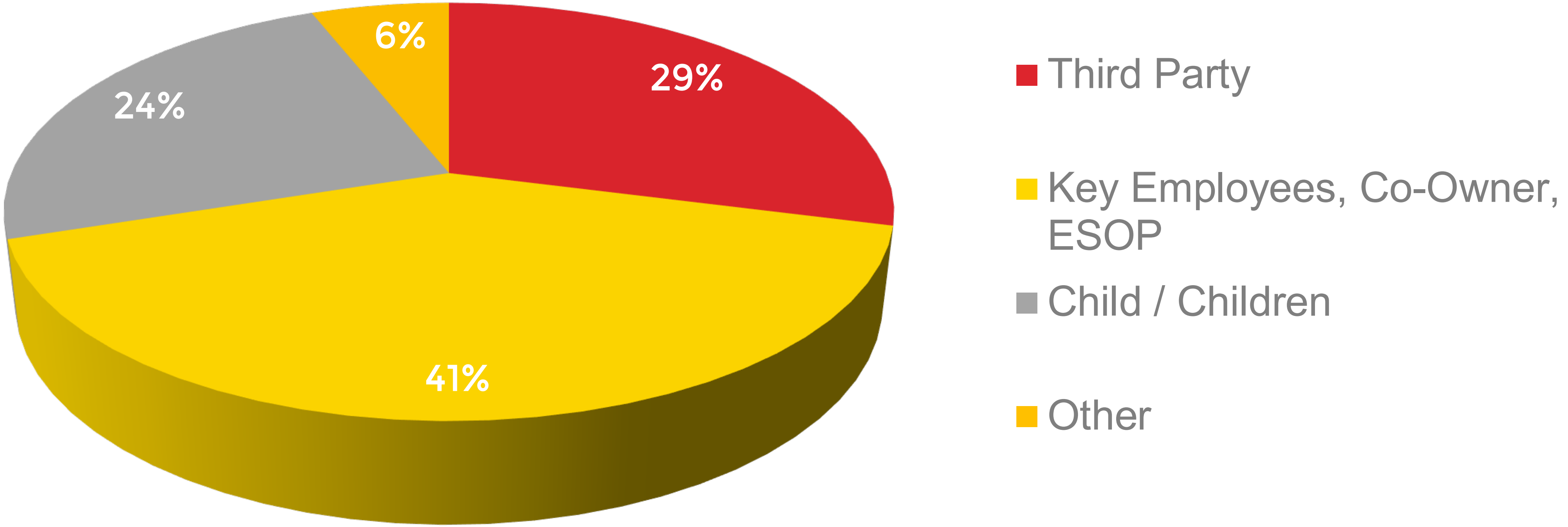
Business Continuity to the Next Generation?



Source: Business Enterprise Institute, Inc. (2012)

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Business Owner Succession Options

- Family Succession
  - Opportunity for next generation
  - Legacy continues
  - Emotional issue
- Sale to Outsiders
  - Owner liquidity
  - Risk / challenges of industry
  - Desire to pursue other interests
- Sale to Insiders
  - Management opportunity
  - Employees (ESOP)

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Why Business Owners Don’t Have Succession Plans

- Don’t have time to deal with the issue
- Too early to plan for succession
- Can’t find adequate advice
- Too complex
- Don’t want to think about leaving
- Conflict with family or employees

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Business Continuity Through Family Succession

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Family Succession

- **Pros**
  - Succession can happen over time
  - Allows you to see how well your children run the business
  - Transfers can reduce estate taxes at death
  - Several planning and transfer strategies available
  - Workforce and legacy remain in place
- **Cons**
  - Unlikely to create full immediate liquidity for seller
  - Typically a longer retirement process
  - Requires children to have the skill and interest to run the company
  - Unlikely to create liquidity for seller

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Types of Family Transfers

- Stock sale
- Asset sale
- Installment sale
- Gifting
- Grantor Retained Annuity Trust (GRAT)
- Intentionally Defective Grantor Trust (IDGT)
- Self Canceling Installment Note (SCIN)
- Family Limited Partnership (FLP)
- Corporate redemption

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Business Continuity Through Sale to Third Party (Outsiders)

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Sale to Outsiders

- Going Public: “IPO Window” difficult, time consuming, expensive
- Strategic Buyers: can justify a premium valuation where other buyers cannot
- Financial Buyers: purchase price based on rate of return business can generate
  - Private Equity; Individual Investors

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Sale to Strategic Buyers

- **Pros**
  - Creates full liquidity for seller (though earnouts may delay full payment)
  - Often allows retirement immediately after close
  - May result in highest price (before tax and after tax)
- **Cons**
  - Likely leads to staff layoffs (driver of higher potential sale price)
  - Business name/legacy ends
  - May not be tax favorable
  - Finding buyer may be strategically unfavorable
- **Other**
  - Requires an industry buyer who may have been a competitor
  - Limited number of potential buyers

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Sale to Strategic Buyer

- **Pros**
  - May create full liquidity for seller (though earnouts and buy-ins delay full payment)
  - Sometimes allows retirement immediately after close
  - Workforce usually stays though management may change
  - Business name and legacy probably continues
- **Cons**
  - Outside buyer may try to change culture/leadership, may not know industry well
  - May not be tax favorable
  - Requires management capable of running the business
- **Other**
  - Many financial buyers (funds and other private equity) often target high growth industries.
  - Price dependent upon rate of return that the buyer believes is achievable

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Stock Sale

- Type of transaction seller desires
- Single level of tax – capital gains rates
- Typically lower sales price but may provide the most after tax cash proceeds
- All liabilities (both known and unknown) transfer
- No “book up” / lack of tax benefit for buyer
- More time spent on due diligence requirement
- 338(h)(10) election to treat stock sale as an asset sale

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Asset Sale

- Type of transaction buyer desires
  - Restart depreciable lives and amounts
  - Goodwill is deductible over 15 years
- Double layer of tax for C corporations
- Ordinary income tax rates
  - Depreciation recapture
- Liabilities defined (environmental could be an issue)

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Non-Tax Issues

- Culture
- Employee matters
- Liabilities assumed
- Amount of due diligence required
- Contracts, licenses, and stock options
- Ability to choose new accounting methods
- Consulting agreements and covenants not to compete
- Cash at closing, earnouts, seller financing
- Reps, warranties, indemnify

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Business Continuity Through Sale to Management/Employees (Insiders)

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Sale to Insiders

- Co-Owners: desire to acquire your shares? Or, wanting to sell when you sell?
- Importance of Buy-Sell Agreement structure
- Ability / financial resources to purchase stock
- Management Buy-Out (MBO): sale to handful of insiders
- Employee Stock Ownership Plan (ESOP): sale to all employees

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Sale to Management

- **Pros**
  - Often allows retirement immediately after close
  - Business name and legacy likely continues
  - Usually friendly deal
  - Workforce and legacy remain in place
- **Cons**
  - Unlikely to create full immediate liquidity for seller
  - Requires management to have the skill to run the company as well as both the interest and financing to buy the company

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Business Continuity Through ESOP Employee-Ownership

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Sale to Employees (ESOP)

- **Pros**
  - Allows seller to have significant control over when to retire
  - Workforce stays and becomes beneficial owners
  - Business name and legacy continues
  - Usually friendly deal
  - Legacy remains in place
  - Can be done in stages or all at once
  - Many favorable tax advantages to ESOPs and may lead to net proceeds being higher than outside sale
  - On average, research shows that ESOP companies are more profitable and grow faster than similarly sized companies in same industry
  - May be less expensive to implement than sale to outsiders

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Sale to Employees (ESOP)

- **Cons**
  - Unlikely to create full immediate liquidity for seller (can be done in stages)
  - Requires management to have the skill to run the company
  - Company needs to have sufficient cash flow to service the debt used to pay out the owner
  - Company needs to have some size (usually 20+ employees)
  - Seller likely to be paid out over time (not immediately)
  - If in place, an ESOP does require ongoing costs to maintain
- **Other**
  - ESOP regulated by ERISA

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Why Consider Forming an ESOP?

- Tax-advantaged buyer of company stock
  - S corporations with an ESOP do not pay federal income taxes for the portion of their stock owned by the ESOP
  - C corporation shareholders - §1042 Rollover allows for capital gains tax deferral on sale
  - Known buyer/exit strategy
  - Diversify seller's net Worth
- Non-tax reasons to consider an ESOP

ESOP Candidate Profile

- Owner approaching retirement
- Capable management team to succeed owner
- Unused debt capacity
- Profits to support ESOP debt service
- Company size (more cost-effective benefit)
- Motivated by tax advantages
- Motivated by “ownership culture” advantages
- Desire to buy out a minority shareholder
- Limited third party / strategic buyers in market

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Am I Prepared?

Owner Readiness Questions

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Meeting

Am I Prepared?
10 Owner Readiness Questions:

1. Have spent some time and money getting educated on the process of how to transition your business. You have discussed transitioning your business with your loved ones.
2. Your personal, financial, and business goals are aligned – they are defined, codependent, and linked.
3. You have established a transition advisory team.

Am I Prepared?
10 Owner Readiness Questions:

4. You have created and reviewed with key advisors and family members a contingency plan which should include buy-sell instructions, appropriate insurance, and specifies what should happen if you could no longer operate the business.
5. You have completed a strategic analysis, business valuation, and personal, financial, and business assessment(s) within the last year.

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Am I Prepared?
10 Owner Readiness Questions:

6. You have considered all of your exit options and optimal deal structure and weighed the pros and cons of each in relation to your stated goals and objectives.
7. You have a written transition plan.
8. You have designated a post-business life-after plan and it is linked to your wealth management plan.

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Am I Prepared?
10 Owner Readiness Questions:

9. You have a pre-transition value enhancement / preliminary due diligence project underway to de-risk the business, maximize its value, minimize taxes upon transition, and improve the probability of a smooth transition to the next owner (including family).
10. You have a management program underway to ensure the post-transition leadership is capable of operating the business without you at the helm.

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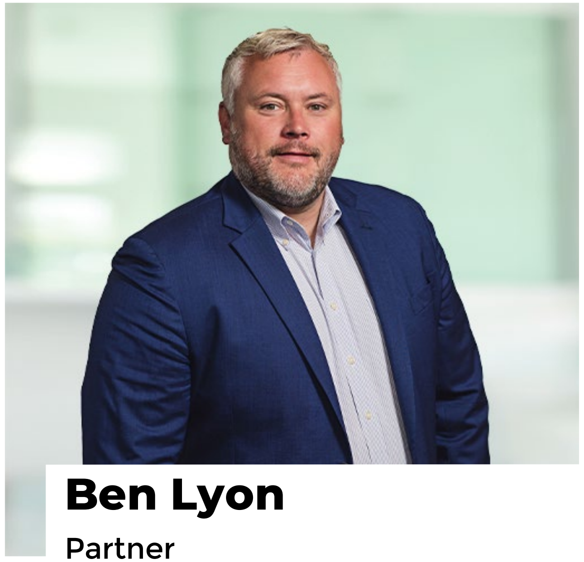
Presenters



Ben Lyon
Partner

blyon@ksmcpa.com

Brittany Schutter
Director
bschutter@ksmcpa.com

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