

Tax (and other) Considerations in Business Exit Planning

Taxation Law Section

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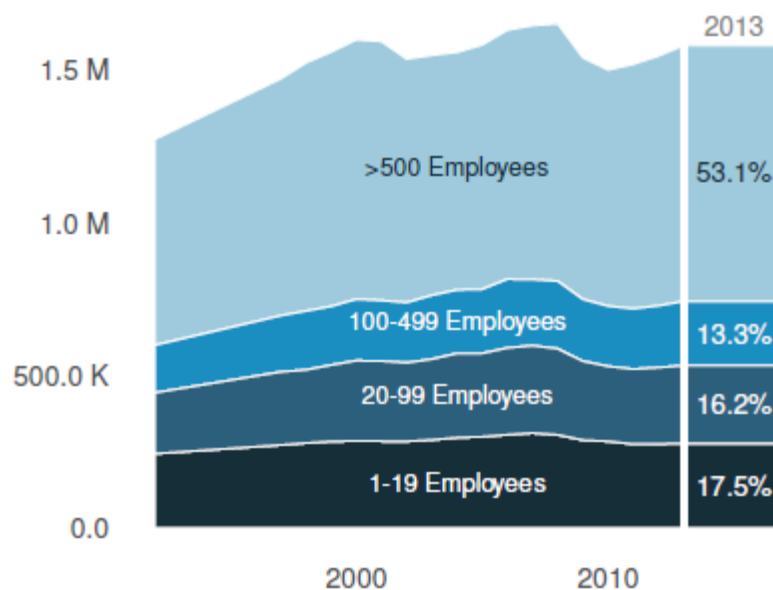
What is a small business?

Defined by the SBA as “an independent business having fewer than 500 employees.”

South Carolina Small Business Profile:

- In 2016 there were 384,274 small businesses, which made up 96.9% of all South Carolina businesses.
- In 2016 South Carolina small businesses employed 743,262 employees, 46.9% of the private South Carolina work-force.

Figure 1: South Carolina Employment by Firm Size



Regardless of the circumstances, exiting a business is much improved if the owner has given forethought and planning to the circumstances surround the exit.

Process of Exiting A Business

- Small businesses make up a large portion of potential clients, and they are largely a group that is in a state of constant transition—starting, growing, acquiring, selling, succeeding, failing. At certain times in this process a small business owner (“Owner”) will desire to exit his or her business. This exit may arise due to positive circumstances (i.e., sale of the business for a

desirable price, or a well planned retirement), or it could be due to negative circumstances (i.e., unexpected death, disability, or business failure).

- Most Owners focus on running and building their business, and often fail to plan for an exit until it is too late. Even for those Owners nearing retirement, an exit always seems to be 3-5 years in the future.
- For family businesses, less than 35% survive the transition from the first to the second generation. Of those businesses that make it to the second generation, only 50% make it to a third generation.¹
- Most small businesses do not have a succession plan in place, but an Owner will eventually exit the business in one of the following ways, whether the business or the Owner are ready for such a transition or not:
 - Business failure/ bankruptcy
 - Death
 - Disability
 - Transfer to family or an insider
 - Merger or sale to an outsider
- In preparation of a business exit, a business owner needs to consider five main areas of concern (which often overlap):
 - I. Cash Flow
 - II. Identity of Successors and Transition of Management and Control
 - III. Timing of Transition
 - IV. Structure of Transition
 - V. Tax Issues²

I. Cash Flow

- A. Needs (and wants) of the Owner & his or her spouse
Can the business (or the sales proceeds of the business) sustain the Owner for the remainder of his lifetime, or fund the Owner's next venture?

¹ <http://www.forbes.com/sites/aileron/2013/07/31/the-facts-of-family-business/#f05907546e72>

1. Business Sale
 - a) *Note payments*
 - b) *Interest*
 - c) *Growth and income from marketable securities or fixed payments from Annuity*
 - d) *See Example 1*

2. Gift of Business
 - a) *Requires other assets of the Owner outside the business*
 - b) *May require a longer period of transition for Owner to build up outside assets.*
 - c) *See Example 2*

B. Capability of the Business

1. Can the business sustain the cash flow that the Owner desires or requires in order to retire?

2. What type of capital strain will be put on the business or the successors in achieving a certain number for an internal transition?

3. In the event of a sale to a third party, would the purchase price be sufficient to support the remaining needs of the Owner?

C. Solutions for cash flow needs:

1. Outside assets and investments
If an Owner is exiting for the purpose of retirement, he or she may have sufficient assets outside the business for retirement.
 - a) *Deferred compensation*
 - (1) Qualified plans (401(k), 403(b), 457(b), etc.)
 - (2) Non-Qualified plans under IRC §409A
 - b) *Marketable securities*
 - c) *Other income producing assets*

2. Continued wages or other compensation after transition
 - a) *Continued salary*
 - b) *Consulting agreements*

c) *Director fees*

D. Cash flow needs of the Owner's children

1. Are the Owner's children currently working in the business?
2. Is their salary consistent with what they can otherwise earn in the market?
3. Are other living expenses of the family tied to the business?
 - a) *Vehicles*
 - b) *Vacation homes*
 - c) *Health insurance*
4. Possible Solutions:
 - a) *Children get a job elsewhere*
 - b) *Grantor Retained Annuity Trust ("GRAT") to a family trust*

In this context, the older generation must have sufficient assets outside of the business in order to make the initial gift to the GRAT. The ideal situation for this strategy is where the older generation has sold the business to an outside party for cash, or has the ability to utilize marketable securities for the benefit of the younger generation.

(1) GRAT Basics³

- (a) Owner establishes an irrevocable trust which is set to expire at a certain date in the future (generally somewhere between 2 and 10 years from the date on which it is established).
- (b) During the GRAT term, the GRAT would make annuity payments to the Owner with a current value equal to the amount of the initial gift.⁴
- (c) The value of the annuity payments and the remainder of the GRAT are calculated based on the federal interest rate at the time the GRAT is created (currently 2.4%).

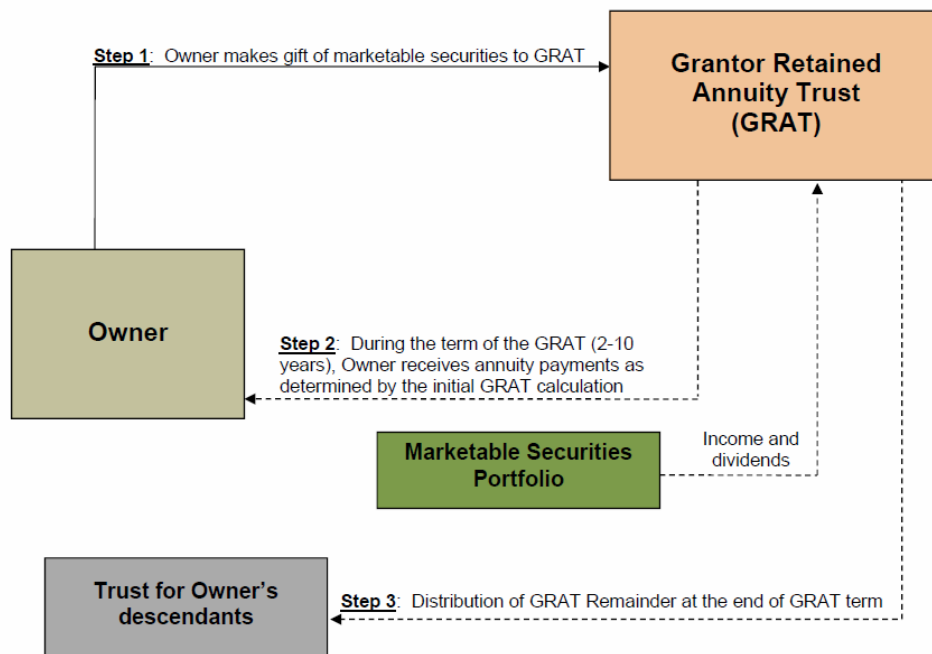
³ See IRC §2702

⁴ See *Walton v. CIR*, 115 T.C. 589 (2000).

(d) If the rate by which the securities transferred to the GRAT grow is greater than 2.4%, the remainder beneficiaries (the Owner's children) will receive the additional increase in value without any gift tax consequences (i.e. to the extent that the property transferred to the GRAT increases in value at a greater rate than the federal interest rate, the Owner would make a tax free gift).

(e) At the end of the GRAT term, the remainder would pay to a trust for the benefit of the Owner's children.

(f) This trust could then be used to supplement the income or benefits that the children lost from the Owner's business.



II. Identity of Successor Owners and Transition of Management and Control

A. Family Members as Successor Owners (Beneficial Interest v. Control)

1. If Owner's children will receive only a beneficial interest in the business, such a restricted transfer can be accomplished in any number of the following ways:

- a) *Transfers of non-voting equity interests (even subchapter S corporations can have non-voting stock)⁵*
- b) *Transfers of interests in the business to trusts for the benefit of the Owner's children*

The strategies above require that an outside manager be brought in to run the business.

2. If one or more children of Owner will control the business:

- a) *Children would also control the management and operation of the business.*
- b) *What if some children are more competent to run or control the business than others?*

As an Owner's children grow, the Owner must determine which, if any, of his or her children have the ability and desire to continue to own or operate the business. If there is ability and desire, the Owner must then determine how to benefit any children who are not going to be a part of the business.

This can be accomplished in a number of ways, including:

- A gift or devise of the business to all children equally with a buy-sell agreement in place between children giving the child active in the business a right to purchase the interests of the other children at market value.
- A gift or devise of the business to the child active in the business with provision for the non-active children through life insurance or by transfers of other assets.
- A devise of all assets equally to all children, with specific provisions in the will or trust permitting a child active in the business to elect the business be used to fund his or her share of the estate.

B. Insiders as Successor Owners – employees or partners

⁵ IRC §1361(c)(4).

1. Sale to Partners – in a sale to a partner, careful planning is still required.
 - a) *How will the price be determined?*
 - b) *Will the transaction be seller financed or paid in cash (or with bank financing)?*
 - c) *Is there a buy-sell agreement in place?*
 - d) *If there is more than one potential partner to purchase the interest, will all partners purchase in equal shares?*
 - e) *Will the transaction be structured as a redemption or a cross-purchase/sale?*

2. Sale/Transfer to Employees
 - a) *How will the price be determined?*
 - b) *Will the transaction be seller financed or paid in cash (or with bank financing)?*
 - c) *Can the employee(s) buy out the Owner at once, or will there be a transition period.*

C. Outsiders – negotiated sale of equity interests or assets

III. Timing

A. Emergency Business Exit – The timing of any succession that occurs as a result of the death or disability of the owner is dictated by such death or disability.

B. Voluntary/Planned Business Exit:

1. Often the timing of an exit transaction will be determined first by the cash flow analysis. If the owner does not have “enough” in his or her mind for future goals, or the business will not fetch a purchase price that will meet the Owner’s needs or wants for such future goals, a voluntary succession will not move forward.

2. If the Owner has sufficient assets, or will acquire sufficient assets in his or her exit, the timing of an exit transaction likely will be determined based on when the successors are prepared to manage the business.

IV. Structure – Sale v. Gift v. Bequest

The structure of an exit transaction is first determined by the cash flow analysis, and then by the tax considerations of the options available.

V. Tax Considerations

A. Gift and Estate Tax

1. Possible Repeal – The election of Donald Trump has brought a lot of uncertainty to the world of tax planning. The proposed Trump tax plan called for the repeal of the estate tax, with it being replaced by a capital gains tax payable on assets left to heirs at death above a \$10 million exemption.

2. Rate – Flat 40% on all amounts above the Unified Credit. The exemption equivalent for 2017 is \$5,490,000. With portability⁶ that is a total of \$10,980,000 that a married couple can transfer before having to pay tax.

3. Gratuitous Transfers of Business Interests

a) *Valuation Discounts*

For gift tax purposes, the amount subject to gift tax is the fair market value of the property transferred on the date of its transfer. For estate tax purposes, the amount subject to estate tax is the fair market value of the property owned as of the owner's date of death. The fair market value of an interest in a family business is the value that a hypothetical willing buyer would pay a hypothetical willing seller for the business interest at the date of transfer. If the rights of the Owners in a family business are restricted (pursuant to a buy-sell agreement, operating agreement, state law, etc.), the interests in the business typically would sell at a reduced amount from the value of the enterprise.

Determining the amount of the valuation discount that applies to an interest in a business is not an exact science. Because there is no active market for small business interests, Owners often engage a valuation expert to appraise the business interests for federal gift and estate tax purposes. The IRS can, however, challenge the value of the interests. The amount of each discount depends on the specific facts and circumstances of each case. Recently, there has been concern that Congress may place restrictions on the use of valuation discounts or eliminate them entirely.

⁶ See IRC §2010(c)(4).

On August 2, 2016, the Treasury released proposed regulations under IRC §2704 that may have threatened to reduce or eliminate valuation discounts in family-owned businesses. However, with the election of Donald Trump, it appears that the proposed regulations will not be made final.

b) Method of Transfer

- (1) Outright transfer during life or at death
 - (a) Income Tax Basis of Transferee
 - (i) *IRC §1014 – income tax basis for property transferred at death is stepped-up to the fair market value of the property*⁷
 - (ii) *IRC §1015 - income tax basis for property transferred by gift or in trust during life is the same as the basis of the property in the hands of the donor*
- (2) GRAT (see discussion above)
- (3) Transfers in trust
 - (a) Additional creditor protection for beneficiaries⁸
 - (b) Ensures that business interest remains a non-marital asset in case of divorce

4. Transfer Tax Issues at Death

How to Pay the Estate Tax

(Estate tax is due in full 9 months from the Owner's date of death)

- (1) Liquid Assets outside the Business
- (2) Irrevocable Life Insurance Trust
 - (a) Single Life Policy v. Survivorship Policy
 - (b) 3-year look back rule for estate inclusion
 - (c) Are Owner (and spouse) insurable?
- (3) Elective Extension of Time to Pay Estate Tax on Interests in Closely Held Businesses
 - (a) If the value of an interest in a closely held business exceeds 35% of the adjusted gross estate of the Owner, the Owner's executor (or personal representative in SC) may elect to pay part or all of

⁷ In the event that an estate elects for alternate valuation under IRC §2032 or §2032A, the basis would be the value determined under such alternate valuation section.

⁸ S.C. Code of Laws (1976) §62-7-501 *et. seq.*

the estate tax in 2 to 10 equal installments, which begin after an interest-only deferral of up to 5 years.⁹

(b) There can be an acceleration of the amount due upon certain dispositions of the business interests or distributions from the business.

B. Income Tax

1. Rates and Basics

a) Rates

(1) Maximum Capital Gains Rate is 30.8% (20% federal + 7% SC + 3.8% NIIT)

(2) Maximum Ordinary Income Rate is 47.5% (39.6% federal + 7% SC + 0.9% Additional Medicare Tax)

2. Stock Options

a) *The employee is taxed on the value of the shares when they become vested. Amounts recognized as income are taxed at ordinary income rates.*

b) *Alternately, the employee may make an IRC § 83(b) election to be taxed on the value of the stock as soon as it is rewarded. By making this election, the employee converts any future appreciation of the restricted stock from ordinary income to capital gains.*

c) *The FMV of the stock at the time the employee has a vested right to the stock is wages subject to FITW, FICA and FUTA.*

3. ESOPs – Defined Benefit Plan under ERISA

4. Sale

a) Sale to Family

(1) IRC §267 – Disallowance of losses

(2) Importance of accurate valuation:

If the purchaser pays less than the fair market value for the business interest, the difference between the fair market value and the purchase price will be considered a gift. The filing of a gift tax return to comply with the adequate disclosure requirements under §301.6501(c)-1(f) will cause the statute of limitations (3 years) to run on the valuation of the sale.

⁹ IRC §6166(a)(1).

b) *Sale to a Third Party*

(1) **Stock Sale v. Asset Sale** – In general purchasers prefer to purchase the assets of a business as opposed to purchasing all of the equity owners' interests in the business entity which owns the business for several reasons:

(a) Protection from Unknown Creditors of the Business. When all of the stock of a corporation is purchased, the liabilities of the corporation (known and unknown) remain with the entity and the purchaser "inherits" them by default.

(b) Ability to Depreciate Assets for Income Tax Purposes. If the purchaser acquires the assets of a business, it can claim income tax deductions for depreciation of the assets in future years (assuming the purchaser pays more for the assets than their current tax book value). Also, the amount that a purchaser can deduct in the year of acquisition under Section 179 of the Internal Revenue Code ("IRC") is quite generous, and therefore attractive to a purchaser. A purchaser generally cannot depreciate the acquisition cost of stock in another company. The only exception is in the case of a seller that is an S corporation in which case there is an election that can be made to treat a stock sale as an asset sale for income tax purposes (a Section 338 election). This can be a very helpful election in situations in which it makes sense for non-tax reasons to structure a deal as a stock sale rather than an asset sale (i.e., car dealerships or any business with assets that require the consent of a third party to transfer the assets).

(c) Capital Gain for the Seller. In general, sellers doing business as corporations (C or S corporations) will prefer to structure sales as stock sales as opposed to asset sales. In general, the seller will be taxed with capital gain on a stock sale. Note, this is not true in the case of a partnership or an entity taxed as a partnership (such as an LLC). Regardless of how a sale is structured with a partnership, it will essentially be treated as an asset sale. In an asset sale, the seller will usually have to recognize some income at a rate higher than the maximum capital

gain rate (i.e., due to depreciation recapture, allocations to inventory, receivables, etc.).

(d) Double Tax for C Corporations. Another reason a seller might prefer to structure a sale as an equity sale and not an asset sale is if the seller is a corporation taxed under subchapter C of the IRC. If a C corporation sells its assets, the corporation pays income tax at the corporate level – some capital gain and probably some ordinary income as well. Then, if the corporation makes distributions to its shareholders, the shareholders will pay income tax on receipt of the distributions. Therefore, there will be income tax paid twice on the same proceeds of the sale.

(a) Allocation of Purchase Price. This is an important provision in an asset sale for both parties' bottom lines and one that is necessary in order to prevent inconsistent reporting of the transaction to the IRS. The incentives of the parties in negotiating the purchase price allocation are as follows:

<u>Assets</u>	<u>Seller</u>	<u>Purchaser</u>
Inventory	Low b/c Ordinary Income	High b/c COGS
Furniture, fixtures, equipment	Low b/c Recapture (OI)	High b/c short dep. period
Goodwill/Real Property	High b/c capital gain	Low b/c long dep. period
Noncompetition Covenants	Low b/c ordinary income	Low b/c long dep. period
Employment/Consulting Agreement	Low b/c ordinary income	High b/c deductible

- (2) Avoiding the NIIT
 - (a) IRC §1411 imposes a 3.8% tax on net investment income above the statutory threshold amounts.¹⁰
 - (b) However, according to the proposed regulations, if the S corporation has no non-business assets and only one business activity in which the shareholder materially participates, then the gain from the sale is exempt from the NIIT.

c) *Buy-Sell Agreements*

- (1) Redemption Agreement
 - (a) Simpler arrangement with life insurance policies
 - (b) Valuation Issues – If the buy-sell agreement provides for a purchase price different from the fair market value of the business interest, there is a possibility that there may be a gift or compensation to the departing or remaining owners.
 - (c) In a corporation a redemption will be treated as a dividend unless:
 - (i) *Redemption is not essentially equivalent to a dividend;*
 - (ii) *Substantially disproportionate redemption of stock;*
 - (a) After the redemption the shareholder must own less than 50% of the voting power of all classes of stock; and
 - (b) The redeemed shareholder holds less than 80% of the voting stock that he owned before the redemption.
 - (iii) *Complete Redemption of the Shareholder*

¹⁰

Filing Status	Threshold Amount
Married filing jointly	\$250,000
Married filing separately	\$125,000
Single	\$200,000
Head of household (with qualifying person)	\$200,000
Qualifying widow(er) with dependent child	\$250,000

- (iv) *Redemption in Partial Liquidation*
- (v) *Redemption by regulated investment company*

(2) Cross Purchase Agreement

- (a) For an entity with multiple owners, this structure may require complex insurance arrangement. One solution to this is to establish a separate partnership to own the policies.
- (b) In a cross purchase, each purchaser receives additional basis in his or her stock.

Regardless of the method that an Owner chooses in establishing a succession plan, the most important thing for them to do is to take action. Most small businesses are without a plan, which is devastating in the event of an emergency business exit.

Example 1

CURRENT MONTHLY INCOME		MONTHLY INCOME (Est.)				DIFFERENCE			CURRENT ACCOUNT BALANCES		
		"Child 1" Principal & Interest	\$10,696						Checking Account	\$702,640	
"Business" Dividend	\$24,568	"Child 2" Principal & Interest (Annuity)	\$11,030						Owner - 401k	\$348,514	
"Business" Salary	\$1,432	"Business" Salary	\$8,250						Spouse - 401k	\$169,671	
Social Security	\$1,583	Social Security	\$1,583						Total Accounts	\$1,220,825	
401k	\$1,000	401k	\$1,000								
Gross Income	\$28,583	Gross Income	\$32,559			\$3,976					
Taxes	-\$8,575	Taxes	-\$5,095			-\$3,480					
Net Income	\$20,008	Net Income	\$27,465			\$7,456					
YEAR	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025
AGE	73	74	75	76	77	78	79	80	81	82	83
"Child 1" - Principal & Interest	\$128,348	\$128,348	\$128,348	\$128,348	\$128,348	\$128,348	\$128,348	\$128,348	\$128,348	\$128,348	\$128,348
"Child 2" - Principal & Interest (Annuity)	\$132,361	\$132,361	\$132,361	\$132,361	\$132,361	\$132,361	\$132,361	\$132,361	\$132,361	\$132,361	\$132,361
Total "Business" Payroll	\$99,000	\$99,000	\$99,000	\$99,000	\$99,000	\$99,000	\$99,000	\$99,000	\$99,000	\$99,000	\$99,000
Social Security	\$19,000	\$19,000	\$19,000	\$19,000	\$19,000	\$19,000	\$19,000	\$19,000	\$19,000	\$19,000	\$19,000
401(k) Distribution	\$12,000	\$12,000	\$12,000	\$12,000	\$12,000	\$12,000	\$12,000	\$12,000	\$12,000	\$12,000	\$12,000
Total Tax	-\$73,565	-\$69,192	-\$68,262	-\$67,432	-\$66,439	-\$65,413	-\$64,612	-\$63,775	-\$62,899	-\$61,982	-\$61,024
Estimated Annual After Tax Cash Flow	\$317,143	\$321,517	\$322,447	\$323,277	\$324,270	\$325,296	\$326,097	\$326,934	\$327,810	\$328,726	\$329,684
Monthly Total Cash Payments	\$26,429	\$26,793	\$26,871	\$26,940	\$27,022	\$27,108	\$27,175	\$27,244.51	\$27,317	\$27,394	\$27,474
YEAR	2026	2027	2028	2029	2030	2031	2032	2033	2034	2035	
AGE	84	85	86	87	88	89	90	91	92		
"Child 1" - Principal & Interest	\$128,348	\$128,348	\$128,348	\$128,348	\$128,348	\$128,348	\$128,348	\$128,348	\$128,348	\$128,348	\$2,566,954
"Child 2" - Principal & Interest (Annuity)	\$132,361	\$132,361	\$132,361	\$132,361	\$132,361	\$132,361	\$132,361	\$132,361	\$132,361	\$132,361	\$2,647,219
Total "Business" Payroll	\$99,000	\$99,000	\$99,000	\$99,000	\$99,000	\$99,000	\$99,000	\$99,000	\$99,000	\$99,000	\$1,980,000
Social Security	\$19,000	\$19,000	\$19,000	\$19,000	\$19,000	\$19,000	\$19,000	\$19,000	\$19,000	\$19,000	\$380,000
401(k) Distribution	\$12,000	\$12,000	\$12,000	\$12,000	\$12,000	\$12,000	\$12,000	\$12,000	\$12,000	\$12,000	\$240,000
Total Tax	-\$60,019	-\$58,970	-\$57,874	-\$56,727	-\$55,527	-\$54,272	-\$52,960	-\$51,587	-\$50,152		-\$1,222,683
Estimated Annual After Tax Cash Flow	\$330,690	\$331,738	\$332,835	\$333,982	\$335,181	\$336,436	\$337,749	\$339,121	\$340,557		\$6,591,490
Monthly Total Cash Payments	\$27,558	\$27,645	\$27,736	\$27,832	\$27,932	\$28,036	\$28,146	\$28,260	\$28,380		\$27,465

