StatonWalsh

Financial Clarity Through Transparency

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Business Succession - Selling Your Business

The owner of a closely-held business faces a series of unique problems when planning to sell his or her interest in the business. Typically, an owner who would like to retire from a business can anticipate some difficulty in finding a buyer who is both willing and able to pay market value for the business, and who will be able to profitably operate the business once the retiring owner is gone. Careful planning can allow an owner to successfully make this transition, achieve a profitable sale of the business, manage the risks associated with operating the business during the transition, and reduce any potential income tax liability.

Necessary pre-sale planning includes ensuring that the business books and records are in order, all tax filings are current, any significant collections or legal issues are resolved, employee benefits are current and paid, and outstanding business debt is at a minimum. These key preparatory steps can add significant value for a potential buyer.

A Buyer for the Business

- **Employees:** Current employees, either key employees or other employees who have indicated an interest in managing the business, can be highly motivated buyers for the business.
- **Family members:** Children or other family members may be interested in purchasing the business.
- **Competitors:** Other business owners in the same field may wish to expand their operations.
- **Suppliers:** Suppliers or vendors may have an interest in the business.
- **Business broker:** An experienced business broker, one familiar with the specific industry or profession, can be helpful in finding a qualified buyer.

A "Phased-In" Transaction

If appropriate, ownership can be transferred over a period of time, allowing the new owner time to adjust to the responsibilities of management and providing for an orderly continuation of the business as the retiring owner has less and less involvement with daily business operations. The sale agreement can:

- Provide for shared ownership and control during the transition to the new ownership.
- Create an orderly transition between owners.
- Minimize potential conflicts that could disrupt successful business operations.
- Create incentives for the parties to successfully operate the business for the benefit of both.

Funding the Sale

In some instances the buyer will have the resources to pay the full purchase price, in cash. Borrowing the money, the sale of other assets, or private investors are all possible sources of funds.

Very often, however, the retiring owner will need to finance all or part of the sale and receive payments for the balance over a period of time. While this approach does entail a degree of risk, the sale can be structured as an installment sale, allowing for the deferral of reporting of both income and capital gain until the year payments are actually received.[1] An installment sale also replaces an income source that might otherwise be lost once the business is sold.

Death or Disability of the New Owner

If a retiring owner chooses to finance the sale of the business, continued payments are often dependent on the successful operation of the business by the new owner. In the event of the death or disability of the new owner, the business may fail and payments to the retired owner stop. The retiring owner can protect against these risks by requiring, as a part of the sale agreement, that life and disability insurance be purchased on the new owner, with benefits payable to the retiring owner.

Income Tax Considerations

There may be a significant income tax liability when the business is sold. Under an installment sale, the interest portion of each payment is treated as ordinary income. A sale of a business also usually involves capital gains or losses, although the tax treatment is dependent, in part, upon the form of the business entity sold:

[1] The discussion here concerns federal income tax law. State or local law may differ.

- **Sole proprietorship:** A sole proprietorship is not considered a separate entity apart from the assets of the business. The sales price is allocated among each of the individual business assets, with a resulting gain or loss reported for each asset.
- **Partnership:** An owner who sells a partnership interest generally realizes a capital gain or loss on the difference between the amount realized less the adjusted basis of the partnership interest. The sale of certain assets such as inventory may be treated as ordinary income rather than capital gain.
- **Limited liability company (LLC):** The federal government does not recognize an LLC as an entity classification for income tax purposes. An LLC must file as a sole proprietorship, a partnership, or a corporation.
- **Corporation:** An owner of a corporation can either sell his or her corporate stock or the assets of the corporation:
  - *Sale of corporate stock*: From the retiring owner's perspective, a sale of corporate stock is highly preferable, since the resulting capital gain or loss is realized only by the retiring owner, with, generally, no tax impact to the corporation. A portion of certain qualified Small Business Stock sales may be excluded from tax.
  - *Sale of corporate assets*: From a buyer's perspective, however, a sale of corporate assets is usually preferable since the buyer receives a basis in the assets equal to the purchase price. If the seller is a "C" corporation, an asset sale can result in a double tax liability; any gain is taxable to the corporation, with additional tax payable by the shareholder when the corporation is dissolved and funds distributed. If the seller is an "S" corporation, tax liability is generally paid by the shareholder, but a corporate tax may also be due if the asset sale results in any built-in gains.

Seek Professional Guidance

The successful sale of a business interest requires careful planning, sometimes well in advance of an actual transaction. The guidance of experienced tax, legal, insurance, and other financial professionals is strongly recommended.

Commonly Asked Business Continuation Questions

The following are commonly asked business continuation questions. Each question is followed by an answer that highlights the issues and the importance of taking action.

Question: What's the problem?

Answer: Think about the essence of a closely-held business. If it's like most firms, it has these characteristics.

- The majority stockholders actively work and manage the business and are critical to its operation.
- The majority stockholders receive most of their income from salary or bonuses.
- Stockholders have limited creditor liabilities.
- If a stockholder were to die or become permanently disabled, the legal structure of the business would survive.
- If a stockholder were to die or become permanently disabled, the personnel structure would be significantly changed.

The problem is, when a business owner dies, the business often dies too: not because anything wrong has been done but because nothing has been done, and that's wrong!

At death (or disability), no asset tends to deteriorate as quickly or as totally as a business. Often, the precipitous drop in value is staggering!

Think about it. If a friend owned a car or a home or almost any other tangible asset, one month after that friend died, the value of that car or home would be relatively the same. But if the friend owned a restaurant that didn't reopen for a month or was a doctor whose practice was closed for a month or owned a manufacturing plant which produced no goods for a month, what would the business be worth at the end of that month?

Question: Why can’t leaving the business to the proper parties in a will or trust solve the problem?

Answer: Leaving the business to successors at death through will or trust provisions does not address the key problems. A disgruntled heir or a dissatisfied spouse may attack a will or trust. Often, part of the business ends up in the hands of inactive heirs who can add little to the business but who want income equal to working stockholders. The result is an increased probability of business failure and inevitable family discord. Most importantly, a will or trust cannot address the central problems created when a business owner dies or becomes permanently disabled.

Look at these four points, seen from the perspective of a surviving stockholder and the decedent's survivors.

Surviving Stockholder	Decedent's Survivors
Continue reasonable salaries	Pay dividends and hire family
Build and expand the business	Pay dividends and hire family
Maintain a long-term outlook	Pay dividends and hire family
Build a strong cash reserve	Pay dividends and hire family

A surviving stockholder doing his or her own job, and probably that of the deceased co-stockholder as well, would want at least the same salary as before, if not a greater salary, in recognition of the increased responsibilities. And the surviving stockholder may want profits plowed back into the business rather than being paid out as dividends.

On the other hand, the heirs of a deceased stockholder would want the corporation to pay dividends and/or hire one or more family members at the highest possible salary. Typically, lots of income will be needed to maintain the current living standard and to pay the unexpectedly high debts, taxes, and expenses that accompany death.

This is why the death or long-term disability of a stockholder almost always creates conflicting interests and dissension.

Question: What happens after a stockholder's death or disability?

Answer: When a working stockholder dies or becomes permanently disabled, there is inevitably a reorganization of the business.

The remaining stockholders generally must:

- Buy out the heirs;
- Sell out to the heirs;

- Accept the purchasers of their stock as business associates; or
- Take the heirs into the business and share profits and decisions.

Is it possible to take one of these courses of action now? Given a choice, which course of action is realistically the most appealing?

Question: Can one be more specific about the problems and objectives of the heirs?

Answer: This can be answered by thinking about the following questions.

- If the heirs are invited to take an active part in the operation and management of the business, will they have the training, experience, ability, and willingness to carry their load and earn their salaries?
- Will all the surviving stockholders be comfortable with the new arrangement?
- If the heirs decide to trust the surviving stockholder to run the business and take care of them and remain inactive, will the dividends the firm pays be sufficient for their needs and meet their expectations?
- Will the heirs panic if business income must be re-invested back in the business rather than paid out to them as dividends?
- How will the heirs react if the surviving stockholder decides to sell stock to an outside party? Where will that leave them?
- If the heirs decide to sell their stock to an outside party, will they obtain a price they feel is fair and adequate, or will the price they need for the stock be more than a knowledgeable buyer is willing to pay?
- Do the heirs know the true value of the stock?
- Can the heirs find a buyer at a reasonable price, or at any price, if they hold only a minority interest?
- Will the surviving stockholder lose his or her job if the heirs own, and then sell, their majority interest?

Question: What are the objectives of the surviving stockholder when another stockholder dies or becomes permanently disabled?

Answer: Typically, a surviving stockholder will want to retain control. Retaining control and preventing outsiders from interfering in the management of the business and its affairs will be crucial objectives. If the business has elected S Corporation treatment (pass through of taxation), the surviving stockholder will want to be sure that election is not lost (which could easily happen if the stock falls into the wrong hands). Further, it will also be desirable to have the cash to guarantee a fair payment to buy out the deceased co-stockholder's heirs.

Question: What are the odds that death or disability could actually occur between two co-stockholders?

Answer: If either event does occur, the probability against it happening doesn't really matter, does it? But it is helpful to at least know what the actuaries know.

Probability of Death Prior to Age 65[1]

Probability of Death Prior to Age 65	Ages of Business Owners
33.7%	25/25
32.9%	30/30
31.8%	35/35
30.5%	40/40
28.7%	45/45
25.9%	50/50
21.3%	55/55
40.2%	25/30
39.3%	30/35
38.2%	35/40
36.8%	40/45
34.8%	45/50
31.5%	50/55

Note: Statistics courtesy of NumberCruncher Software, version 2007.04. June, 2008. (610.527.5216).

Question: What's the solution to all of these problems?

Answer: A legal agreement called a buy-sell agreement is often the best solution. The document, prepared by an attorney, is a legal instrument which requires the corporation (in

[1] The probability that one of two business owners in average physical condition will die prior to age 65 is illustrated.

the case of a stock redemption agreement) or the remaining stockholders (in the case of a cross-purchase agreement) to buy the stock of a deceased, retiring, or permanently disabled stockholder. It would require the estate of the stockholder to sell under a formula devised while all parties are alive and well.

There is even a type of buy-sell agreement that combines the flexibility of both the stock redemption and the cross purchase. This is called a wait-and-see buy-sell agreement. With it one can wait and see the best course of action, tax-wise, and then take it, even many years after the agreement is drafted.

Question: How is this agreement funded? Is there a perfect buy-sell funding mechanism?

Answer: There's no free lunch or perfect buy-sell funding vehicle. The ideal is a method that will facilitate a trouble-free transfer of the business interest and provide funds for that purchase in a manner that:

- Is relatively inexpensive;
- Is easy to administer; and
- Will not adversely affect the business or the surviving stockholder’s working capital or credit position.

Since two of the most common causes of ownership termination are death and long-term disability, the financial mechanism chosen must provide ample amounts of cash, at the time needed most, whenever that occurs!

Question: What are the various funding alternatives?

Answer: There are four ways to fund a buy-sell agreement. They are using cash on hand, borrowing, making installment payments, and through life and/or disability insurance.

Here are some thoughts and questions that should be discussed with the business planning team.

- **Cash.**
  - How much cash will be required and will it be available when needed?
  - When will that cash be needed?
  - What will happen if the cash is unavailable due to an unforeseen situation?
  - Will after-tax dollars need to be kept on hand to finance the purchase?
  - Will a higher alternative rate of return have to be sacrificed in order to keep adequate cash on hand?

Commonly Asked Business Continuation Questions

- **Borrowing.**
  - Will the firm or the surviving stockholders be able to borrow money after the death or long-term disability of a stockholder/employee?
  - What rate of interest will be required and would it be deductible?
  - How serious will the cash drain impact be on corporate or personal reserves?
  - How will the borrowed funds be repaid?
- **Installment payments.**
  - Can the decedent's family afford to leave substantial sums of money at the risk of the business?
  - Where will the deceased stockholder's family obtain cash to pay taxes, debts, and other immediate estate settlement costs?
  - What rate of interest will the decedent's family want to charge on the unpaid balance? Will that interest be deductible?
  - What will the total cost be?
  - Can the business carry the extra debt and still fund company operations and future growth?
- **Insurance.**
  - Will the buyers be guaranteed that the death or disability will create sufficient cash to satisfy that need?
  - Will this method reduce or eliminate the strain on future working capital in return for relatively small, predictable annual transfer of cash to cash values?
  - Can policy cash values be used, before an insured's death, for a corporate emergency or opportunity?

It should be obvious that setting up a buy-sell agreement can be crucial to the survival of a business, as well as essential to guarantee the economic security that the business represents to family and loved ones. Such an undertaking involves a considerable amount of time, thought, and background experience in many areas, as well as teamwork and cooperation among all the members of your advisory team.

Importance of a Business Continuation Plan

Competing Interests of Heirs and Surviving Owners

These interests are many and may include the following:

What Heirs of Deceased Owner Want	What Surviving Owners Want
Top dollar for their interests	Minimum cost for the interest
Prompt settlement of the estate	Prompt transfer of the business interest
Set value of business for estate tax purposes	Full control of the business - no interference from decedent's family
Relief for family from worries regarding the business and its creditors	Continuing relationship with creditors
	Retention of customers and employees

Potential Problems Without a Written Agreement

Frequent results include:

- Heated conflicts among the remaining owners and the decedent's family.
- Unhappiness on all sides, and sometimes litigation.
- Delays in settling the estate and continuing business growth.
- Loss of customers and loss of business value.
- Possible liquidation of the business which may bring less than full value.

The Solution: A Written Agreement (and Cash)

Taking the time now to see that the business will pass in an orderly manner at time of death will benefit all parties and their heirs. A written agreement can provide:

- An orderly transfer of the operation, management, and ownership of the business.
- A mutually agreeable sales price and preservation of business value.
- Mutually agreeable terms of sale.
- A value that is binding on the IRS for federal estate tax purposes.
- Stability for customers, employees, creditors and investors.

An agreement which is favorable to all parties can be more easily drafted prior to a crisis.

Transfers for Value

Life insurance death proceeds are typically exempt from income taxation under IRC sec. 101(a)(1). The gift of a policy during the insured's lifetime does not affect this exemption; however, the sale of a policy may subject part of the proceeds to income taxation when the insured dies. If a policy is transferred for value to a non-exempt transferee, the portion included as taxable income will be the face amount less any consideration (purchase price and subsequent premiums) paid by the transferee.

Exempt Transferees

Parties who can purchase a policy from another and are exempt transferees include the following:

- The insured.
- A partner of the insured.
- A partnership of which the insured is a partner.
- Corporation of which insured is a shareholder/officer.
- Any person where the basis is determined by reference to the transferor's basis, e.g., a gift.

Typical Violations of this Rule

- A policy owner agrees to name another person as a beneficiary in exchange for valuable consideration.
- When two persons assign policies on their own lives to each other at about the same time, the question of a transfer for valuable consideration is raised.
- A corporation changes its buy-sell agreement from a stock redemption plan to a cross purchase plan and transfers key person insurance policies to stockholders other than the insured.
- For estate planning reasons, a corporate key man life insurance policy is transferred to the insured's adult child or an irrevocable trust to keep the proceeds out of the estate. Since neither the child nor the trust is an employee, the policy is usually purchased for its current cash value.

Problem: Neither the adult child nor the trust is an exempt party. Under the transfer-for-value rule the proceeds may be out of the estate, but are partially includable as ordinary income in the year received by the beneficiary.

A better way: Have the insured purchase the policy from the corporation (the insured is an exempt party). He is now free to make a gift of the policy to the adult child or trust; however, the donor/insured must survive the 3-year contemplation of death period to avoid having the policy death benefit included in his or her estate.

Where there is a non-exempt party owning a purchased policy, it may be wise to have the insured purchase it back for its cash value and then, by a later gift, transfer it back to the non-exempt party. This will remove the taint.

Tax Cuts and Jobs Act of 2017

The Tax Cuts and Jobs Act of 2017 (TCJA), generally effective January 1, 2018, made a number of changes to federal tax law governing transfers for value:

- **Reportable policy sale** – TCJA established a new requirement to report certain information when a life insurance policy is acquired in a "reportable policy sale." A reportable policy sale refers to the acquisition of an interest in a life insurance contract, directly or indirectly, if the acquirer has no substantial family, business, or financial relationship with the insured, apart from the acquirer's interest in the life insurance contract.
- **Exempt transferees** – TCJA also mandated that the exceptions to the transfer for value rules do not apply in case of a transfer of a life insurance contract in a reportable policy sale. Thus, some part of the death benefit ultimately payable may be taxable.
- **Determination of basis** – The Act also clarified the calculation of a taxpayer's basis in a life insurance contract.

Seek Professional Guidance

Because of the complex nature of transfer for value situations, the advice and guidance of trained, experienced tax and legal professionals is strongly recommended.

Types of Corporate Continuation Plans

If the owners want to keep the business in the family, but money is needed to pay estate taxes or other estate costs, a partial stock redemption under IRC Sec. 303 should be considered. If the business interest is to be passed to others, several choices are available.

Continuation Plans in Brief

- **First offer of stock to existing stockholder(s):** The stockholders agree not to sell their stock to an outsider during life or at death without first offering it to the other stockholders or the corporation at an agreed price. This plan gives no certainty to a deceased owner's heirs and will not peg the value for federal estate tax purposes.
- **Option to buy:** An agreement giving the corporation (and/or surviving stockholders) an option to purchase a deceased stockholder's shares. Since the estate is required to sell if the option is exercised, the value for federal estate tax purposes may be pegged. The heirs have no certainty since the corporation is not required to purchase the stock.
- **Cross-purchase buy-sell agreement:** A written agreement among the stockholders to purchase each other's shares at the death of an owner. The price is either stated in the agreement, set by a formula, or provides for the use of independent appraisers
- **Stock redemption plan:** Stockholders enter into an agreement with the corporation to have their estates sell their shares back to the corporation at death. The company usually carries key employee insurance policies to finance the payments for the stock.
- **Wait-and-see plan:** A written agreement among the stockholders and the corporation, generally giving the corporation an option to buy the stock. If it elects not to purchase, the surviving stockholders may buy it and, if they don't, the corporation may be required to buy the shares.

Types of Corporate Continuation Plans

Considerations in Choosing a Plan

- What is the value of the corporation and who can afford to buy it?
- How many owners are there and how old are they? What percentage of ownership does each person have?
- What is the net worth of each owner? Are the owners related?
- Are they all insurable?
- What are the individual tax brackets and the corporate tax bracket?
- Does the non-active spouse have any rights, e.g., community property interest?

Funding

Many types of corporate continuation plans are funded with life insurance. Under IRC Sec. 101(j), death proceeds from a life insurance policy owned by an employer on the life of an employee are generally includable in income. If certain regulatory requirements are met, the proceeds can be received income-tax free. State or local law may vary. Professional legal and tax guidance is strongly recommended.

Important Notice

This report is intended to serve as a basis for further discussion with your other professional advisors. Although great effort has been taken to provide accurate numbers and explanations, the information in this report should not be relied upon for preparing tax returns or making investment decisions.

Assumed rates of return are not in any way to be taken as guaranteed projections of actual returns from any recommended investment opportunity. The actual application of some of these concepts may be the practice of law and is the proper responsibility of your attorney.

Disclosure Notice