



Transferring Business Assets

In the future, you may either want to transfer your business to heirs or sell your business to employees, competitors, or others. Planning for transfer of a family business has two main elements, which should be considered separately:

- the transfer of power, whereby control over the business's operation is transferred to those best suited to exercising it; and
- the transfer of assets, whereby the wealth concentrated in the business is transferred to designated family members, who may be a different or larger group than the person or persons who will be assuming power.

What issues do I need to consider when transferring my business to family?

The major issues confronting a family business owner seeking to transfer power to successors are:

- selecting a successor
- intergenerational conflict
- training
- transition timing

Many family businesses will have one member of the next generation who is more active, qualified, and interested in the business than his or her siblings. The challenges come in the form of finding ways to assure equitable treatment for the non-participating family members, be they spouse or siblings.

Ownership may be divided but management should be clearly delineated. Often ownership can be split into passive and active shares, giving the active successor the necessary control over the business but providing an equal economic benefit to the inactive shareholders. In some cases the business can be divided along functional lines, so that different family members can assume control over well-defined functions or business units.

Differences of opinion and approach commonly found between generations and between co-workers of the same generation can be worked out mutually over time to the benefit of the individuals, the family, and the business. Planning and communication are the tools these successful teams must use consistently.

What are some tax-advantaged ways to transfer assets to family members?

Below is a list of some of the more commonly used strategies for minimizing taxation on a transfer of assets:

- liquidity strategies (deferrals, redemptions, buy/sell agreements)
- private annuities
- GRATS
- recapitalizations
- the family office

Valuation of the business is the foundation of all these methods. Wherever possible, periodic reevaluation should be made a part of any technique used. The value of assets transferred either by gift or bequest is subject to a federal tax at graduated rates applied on a cumulative, unified basis. Federal transfer taxes can be reduced by the unified tax credit, which (for 2004 and 2005) is equivalent to exempting \$1,500,000 worth of assets free of tax, but any property in excess of that is taxed. If your business is large enough, you'll need to provide for liquidity so that taxes can be paid without depleting the business's working capital.

Liquidity Strategies

Strategies for acquiring the liquidity needed for the payment of estate taxes can be handled three ways:

1. **By deferral**-Estate taxes on the value of the business interest may be paid over a period of up to 14 years, if the business interest is more than 35 percent of your adjusted gross estate. The business may be in the form of a proprietorship, a partnership or a corporation. The IRS will charge interest at a rate set by law.
2. **By redemption**-The redemption of closely held stock of a corporation is a planning technique that can allow your heirs to maintain control of the company and gain liquidity to pay taxes. Stock can be redeemed with capital gain treatment to the extent that the proceeds of the sale of the deceased's stock are used to pay administrative and funeral expenses. This is an important distinction because without it, the redemption can be treated as a dividend and the entire proceeds (not just excess over basis) would be taxed as ordinary income. To qualify, the 35 percent of gross estate test must be met and the beneficiary must share liability for tax and debts of the estate. Moreover, the company must have enough cash to redeem the stock.
3. **Through buy/sell agreements**-Buy/sell agreements can provide liquidity when the purchaser has funded the purchase price with life insurance on the decedent's life. The other advantages of a buy/sell agreement include the fact that it's an organized plan for the disposition of the business interest. The buy-sell agreement prevents an owner from selling his interests to an outsider without the consent of

the other owners. They can also establish a value which is always a problem in the case of a closely held business.

Frequently, the agreement will be backed by life insurance policies (key man life insurance) on all the principals, so a ready supply of cash will be there when needed. The beneficiaries of a key man policy are the organization or the organization members. The life insurance proceeds can be used by the corporation to keep the business going in the absence of a key shareholder or officer. The proceeds can also be used to buy out a deceased shareholder's interest pursuant to a buy/sell agreement.

To simplify the buy-sell process and ensure fairness for all owners, the buy-sell agreement should specify how the owners' interests are to be valued. Essentially, there are three choices:

- book value
- fair market value
- formula approach

Private Annuities

Where a private annuity is used as a business succession tool, the owner sells (transfers) his business to a family Member in exchange for a lifetime income.

The value of the business will not be included in his gross estate for tax purposes, provided the value of the annuity Equals the value of the exchanged business interest. If the founder dies early, the appreciation in value of his business after the transfer escapes tax. If he lives longer than his life expectancy, the annuity payments will exceed The value of the business. A drawback of a private annuity is that the seller retains no secured interest in the business. A variation of a private Annuity is known as a secured interest note or SCIN, a vehicle where the seller retains a secured interest via a note from a family member. The tax treatment is the same as for a private annuity. The danger here is, if any remaining Payments on the note will be forgiven at the founder's death, then any gains from the forgiveness of debt will be taxed in the estate of the founder.

Grantor Retained Annuity Trust (GRATS)

A GRAT is an irrevocable trust funded with a single contribution of assets, which pays a percentage of the initial Contribution, either fixed or with a predetermined increase (the annuity), back to the donor for a term of years, and then distributes the assets remaining at the end of the term to beneficiaries other than the donor. GRATS are a way to make gifts, and transfer the fair market value of assets, on a discounted basis since only part of the gift gets valued in the irrevocable trust. There are several other forms of trusts, such as charitable lead trusts, grantor retained income trusts (GRITS) that are permutations of this concept.

Recapitalizations

Recapitalization, or the issuance of two classes of corporate stock, is another method used to transfer ownership at minimal tax cost. Stock is generally divided into voting and non-voting categories which permits control to remain with one individual or group, usually the family members who are active in the business. The non-voting stock is used to give provide equity to the inactive family members. There are stringent laws limiting recapitalizations.

The Family Office

Many times where an operating business has been transferred down to the next generation, sold outright, or recapitalized, the family finds it useful to set up a family office for the administration and management of their remaining collective assets. Such an office can fill the gap left when the operating business was sold and no longer there to provide the recordkeeping, tax planning and general support the family members had become accustomed to enjoying over the years. An employee, perhaps a bookkeeper or business manager, is generally hired to run the office. Having an outside third party to administer things and a businesslike location in which to do it can achieve a level of professionalism impossible in a strictly family setting.

What issues do I need to consider when selling my business?

Here are major issues you need to think about when it's time to sell your business:

Initial issues in selling out: how should you time your decision and choose experts to help, and what legal/ethical pitfalls do you need to avoid?

- **Valuations of small businesses:** how does the market put a price on a small business, and what can you do to maximize your own business's value?
- **Finding a buyer:** what do you need to know about working with a business broker, creating a selling memorandum, and other marketing concerns?
- **Structuring the deal:** what are your options as to terms, paying particular attention to the tax implications of various alternatives?
- **Financing the deal:** what should you know about seller financing, and third-party financing through leveraged buyouts?
- **Completing the deal:** from the Letter of Intent through due diligence to the closing, what are the typical steps you can expect to go through in the sales process?

Two important issues relating to exactly what you are transferring in the sale are:

- **Key contracts:** are your important leases, supply contracts, and other agreements transferable to a buyer?
Can a buyer assume your existing loans?

- **Assets vs. stock sales:** if you are incorporated, will you be selling the corporate stock, or its assets?

One issue you should examine closely, when you sell your business, is the transferability of your key contracts. Ideally, your most important contracts, including leases and contracts with customers and suppliers, should be assumable by the buyer. That way, you can get out from under the contract, and the buyer will have the resources needed to conduct business. If important contracts are not assumable, it will affect the buyer's willingness to buy your business since the contracts will have to be replaced or renegotiated. If your business is organized as a corporation, selling stock, rather than assets, can solve the assumption problem since most contracts were probably made with the corporation rather than you personally. This is one reason some buyers may agree to or even prefer a stock sale.

If you rent your facility, try to get your landlord to sign a new lease with the buyer, rather than having you sublet to the buyer. Generally, a sublessor (which would be you) remains liable for the rent if the sublessee doesn't pay, for the duration of the lease.

The assignment of existing loans on the business can be a problem, if you had made personal guarantees to the lender. You don't want to be personally liable for the buyer's success in the business. If you can't get the bank to release you from further liability on the loan, you'll need to make sure that the cash paid at the time of purchase is sufficient to pay off such loans.

What tax issues I should be aware of when selling my business?

There are a number of qualifications to the tax rules and issues that present planning opportunities for sellers (and buyers) of businesses.

- **Ordinary income vs. capital gains:** gains on some of the assets being transferred may have to be taxed at ordinary income tax rates, rather than at the 15 percent maximum long-term capital gains tax rate.
- **Installment sales:** if you defer receipt of the purchase price to later years with an installment sale, you may be able to postpone paying tax on your gains until you receive them.
- **Double taxation of corporations:** for businesses organized as corporations, the structure of the deal as an asset or stock sale can have very different tax results.
- **Tax-deferred reorganizations:** where one corporation is buying another, you may be able to structure the sale as a tax-deferred merger.

Ordinary income v. Capital Gains

The basic issue is that with any sale of a capital asset, including business property or your entire business, you have to pay income tax on your capital gains. Ordinarily the gains are recognized (taxed) in the year of the sale. Under current law, long-term capital gains are taxed at a significantly lower rate than ordinary income. From May 6, 2003, through

the end of 2007, the maximum capital gains rate drops to 15 percent and to 5 percent for the lower income brackets.

If your business is a sole proprietorship, a partnership, or an LLC, each of the assets sold with the business is treated separately. So, the formula described above must be applied separately to each and every asset in the sale (you can lump some of the smaller items together, however, in categories such as office machines, furniture, production equipment etc.). Certain assets are not eligible for capital gain treatment; any gains you receive on that property are treated as ordinary income and taxed at your normal rate, which can be as high as 35 percent in 2003 through 2010.

The problem becomes one of allocation: if you negotiate a total price for the business, you and the buyer must agree as to what portion of the purchase price applies to each individual asset, and to intangible assets such as goodwill. The allocation will determine the amount of capital or ordinary income tax you must pay on the sale (except in the case of corporations, which have the option of structuring the sale as a stock sale.) After the sale, the buyer will be able to depreciate or amortize most of the assets that were transferred. Because different types of assets are depreciated differently under IRS rules, the buyer is going to want to allocate more of the price toward assets that can be depreciated quickly, and less of the price to ones that must be depreciated over 15 years (such as goodwill or other intangibles) or even longer (such as buildings) or not at all (such as land).

Double Taxation of Corporations

If you are incorporated and sell assets, the transaction is normally taxed twice — once when your corporation sells the assets, and again when the corporation is liquidated. At the time of liquidation there will be capital gains tax imposed on the individual stockholders based on their proceeds from the liquidation, minus their basis in the stock. Capital gains tax on your profit from the sale is taxed generally at 15 percent, starting May 6, 2003.

Sometimes this second tax can be deferred to the future, if the corporate "shell" is maintained rather than liquidated. In a family-owned corporation, the shell can become a holding company for family investments (for example, the proceeds of the sale can be held by the corporation and invested). The IRS generally doesn't like this result, so in addition to the regular corporate income tax, the "shell" may have to pay personal holding company tax to the tune of 35 percent (i.e., the highest individual income tax rate in 2003 through 2010). You can generally avoid this result if the shell corporation pays out all its after-tax income as dividends.

Some sellers prefer stock sales, while buyers prefer asset sales, is that with a stock sale, any unknown liabilities the company may have are transferred to the new owner. With an asset sale, the liabilities would remain with the seller. Some examples might be future

product liability claims, contract claims, lawsuits by employees, pension or benefit plan liabilities, etc. stemming from seller's ownership of the company.

From the buyer's perspective, however, asset sales are usually preferable. In an asset sale, the buyer's basis for depreciation is the allocated purchase price of the transferred assets. In a stock sale, the basis of the stock shares is stepped up to the purchase price of the stock. However, the buyer takes over whatever basis the seller had in the assets. If the buyer had already depreciated some of the assets down to zero, the buyer can't claim any more depreciation deductions on them. Clearly, the buyer would much prefer the stepped-up basis of an asset sale.

One point to consider, when you negotiate the issue of a stock or asset sale with the buyer, is that your increased tax bill from an asset sale will usually be greater than the savings the buyer would get from such a sale. A stock sale usually results in the lowest total amount of tax being paid to the IRS, and the most money left in the hands of the parties. Theoretically at least, you should be able to take advantage of a stock sale by adjusting your purchase price to reflect the future tax burden to the buyer. Also, in a sale of stock, the IRS does permit the buyer to elect to have the transaction treated as a purchase of assets (i.e., buyer can get a step-up in basis for the assets), if the buyer pays tax on the difference between each asset's current basis and its fair market value in the year of the transfer.

Electing S corporation status. With an S corporation, there's generally just one tax to shareholders on either an asset or stock sale. If you're contemplating the sale of your business several years down the road, you may want to consider switching to an S corporation now. By doing so you can usually eliminate the double taxation on any appreciation after the date of the switch.

Tax-deferred Reorganization

If your business is incorporated and you are selling out to a larger corporation, it may be possible to defer any tax due on the sale by structuring the sale as a corporate reorganization, and accepting the purchaser's stock in exchange for your own business's stock. If you manage to comply with the IRS's extensive rules for these types of transactions, you won't be taxed on the value of the stock you receive, until you sell it at some point down the road. If you receive other property or tax in addition, however, you'll have to recognize taxable gain to the extent of this "boot."

This type of deal is only advantageous if you are selling out to a buyer whose stock is a good investment. Remember, you'll be exchanging a nondiversified investment over which you had control (your own company) for a nondiversified investment over which you may have little or no control. Under Federal tax laws, you generally can't go out and immediately sell the buyer's stock; you may be required to hold it for as long as two years, or you will lose the tax-free status of the transaction. In two years, almost anything can happen to the value of the stock.

Now, with careful legal drafting, these general rules can be altered in the sales contract. For example, in an asset sale, the contract can state that the buyer will assume certain liabilities of the seller. Because third parties won't be bound by the terms of the contract, the contract can also include escrow arrangements or indemnification clauses that will remove some of the buyer's risks, by stating that the seller's money will be used to pay for claims. However, if the drafting is not perfect and anything is left out, the general rules will kick in.

There are some reasons why the buyer may prefer a stock sale in certain situations. If the corporation has a good credit rating, the buyer may want to buy stock. Certain contracts such as leases, supply contracts, or employment contracts may have been written between the corporation and the third party, and it will be easier for the buyer to maintain these contracts if the stock is transferred. Stock sales may also be simpler to carry out since there's no need to transfer and retitle every single asset.

What is a Family Limited Partnership?

“Family Limited Partnership” refers to is a limited partnership formed to hold the family business or investments, with the idea that the parents will make gifts of their limited partnership interests to their children. Because the limited partnership interests are illiquid, so the theory goes, they should be subject to substantial discounts for federal gift and estate tax planning purposes.

Family Limited Partnerships also have some attraction as asset protection vehicles, primarily because the limited partnership interests may be subject to “charging order protection” in some states. As of 2003, no cases in Texas have substantially interpreted charging order protection.