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Tax Planning for the Future Sale of a Business

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BY BRUCE GIVNER

Your client has a successful closely held business. Perhaps your client has already indicated that, at some indeterminate point in the future, the business will be sold. Even if your client has not given such an indication, you are well advised to at least broach the topic as a matter of long-term contingency planning.

Keep It Simple: The first consideration is: why do anything to minimize the tax consequences? Isn't the best approach to pay the tax, pocket the difference and be glad? The answer is, most often, "yes." Any steps taken to minimize the tax on the sale have a cost, and simplicity includes the elimination of those costs. Take the money and run or, better yet, take the money, put it into an asset-protected vehicle, and sleep soundly.

However, before we dispense with all thoughts of minimizing the tax on a sale, our clients may, at least, want to know the alternatives. That may especially be the case in states like California where the maximum state tax rate of 13 percent creates a capital gains tax rate of 33 percent!

Installment Sale: An installment sale with the buyer is one way to at least regulate the amount of tax recognized each year. There are two potential problems. First, the seller must trust the buyer to make the future payments. Sometimes no amount of collateral will permit the seller to sleep comfortably at night. Second, Internal Revenue Code Section 453A limits to $5 million per person the amount of installment that can be received without paying an interest charge on the deferred tax. Some taxpayers gladly pay the interest on the deferral above $10 million because they can make more on their money (the interest is currently 3 percent, which means a 50 percent bracket taxpayer must earn 6 percent).

There are at least two alternatives to entering into an installment agreement with the buyer. The most attractive is to enter into an installment agreement with an irrevocable trust for the benefit of the seller's children. This transaction with a non-grantor trust must be consummated more than two years before the sale to the outside buyer. Internal Revenue Code Section 453(e)—colloquially known as the restriction on related party installment sales—does not allow the children's trust to use the note as its basis if it sells the stock in two years or less from the date that it bought the stock from the parent. Most sellers do not get to use more than two years and a day before the sale—yet another reason why the CPA's role in counseling is so important.

The other alternative installment sale is to work with one of the firms that will act, for a fee, as the independent third party to buy the asset for a note and later sell it to the cash buyer. Searching the phrase "deferred sales trust" on the

Internet reveals more than 30,000 results. Many promote it as an alternative to a Section 1031 exchange. Does it work? One firm promotes its receipt of a private letter ruling. Concerns include whether the seller is so secure that the seller is in constructive receipt.

ESOP: If the business is a "C" corporation, then an employee stock ownership plan is worth considering. Most closely held businesses have not been C corporations since 1986. However, the number is likely to rise given the increase in personal rates. Also, the owner of an S corporation or LLC might change the business to a C were the ESOP benefits to be overwhelmingly attractive.

The primary benefit to the owner is the ability to sell the 30 percent or more of the stock to the ESOP and reinvest the proceeds tax free into the stock or bonds of some other corporation. When IRC Section 1042 was first enacted in 1984, the clients would often buy 40-year General Electric Credit Corporation bonds (then desired for their safety). The client's basis in the bonds was, of course, the same as the basis in the closely held corporation stock. The plan was for the parent to die owning the bonds and, as a result, the step-up in basis to the date of death fair market value would eliminate the gain.

ESOPs, of course, have other benefits, e.g., the corporation can borrow money to buy corporate stock and, in effect, deduct the repayment of principal on the loan. Also, the corporation can deduct a non-cash contribution (stock) to a retirement plan.

Charitable Bailout: Use of a charity in connection with the sale of an asset is fraught with risk. In Ferguson, 174 F.3d 997 (1999 Ninth Circuit), the taxpayers gave stock to charities before the sale of their business was legally certain. The charities sold the stock, but the IRS taxed the Fergusons on the gain. The court determined that the sale "was practically certain to occur" and invited the taxpayers to sue their lawyers, writing "Any tax lawyer worth his fees would not have recommended that a donor make a gift of appreciated stock this close to an ongoing tender offer and a pending merger, especially when they were negotiated and planned by the donor." Other cases have not been so extreme, such as Rauenhorst, 119 T.C. 157 (2002).

With that caveat about the assignment of income doctrine, your client can give "C" corporation stock to a charitable remainder trust. The deduction may be zero due to your client's basis in the stock or due to the rules requiring a reduction by 100 percent of the appreciation attributable to the remainder interest. However, the CRT will sell the stock without paying a tax and your client will receive an income for life. On the client's death, the balance in the CRT will be distributed to a favorite charity. If, for example, the charity is a private foundation, the client's children may gain prestige through the determination of which charities receive the annual distributions.

Antiquated Structures: Before 2006 partnerships were used to step up the basis in an asset that was going to be sold. However, on Feb. 9, 2006, the IRS issued its "Redemption Bogus Optional Basis Tax Shelter Coordinated Issue Paper," which effectively terminated that format. Also, private annuities were used to step up the basis in assets before a sale. However, with the use of so-called "private annuity trusts," the IRS put a stop to that by changing the regulations on Oct. 18, 2006. Sales to friendly parties (transactions not covered by Section 453(e)) were made difficult by Section 7701(o)'s codification of the economic substance doctrine, effective March 2010.

There are techniques that you should to discuss with your client who has a closely held business. However, for most clients the best approach, after considering the alternatives, is KISS.

Bruce Givner, Esq., is a partner at Givner & Kaye in Los Angeles. He can be reached at ***Bruce@GivnerKaye.com****.*