CHIEF INVESTMENT OFFICE

# Wealth Strategy Report

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## Sale of Your Closely-Held Business

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The sale of your company can take many forms and can raise many planning issues to consider. This summary will discuss some of these. However, this is a general overview. You will need to involve many financial professionals, including your attorney, accountant and financial advisor.

### FORM OF SALE

The sale of your company can take one of several forms. The form of sale will determine some important consequences, such as the income tax treatment of payments you receive, and your continued exposure to the businesses' liabilities, both discussed further below. In general, the form of sale will likely be one of the following:

1. Sell the stock of the company for cash. The simplest transaction; you and the other shareholders would simply sell your stock for cash.
2. Sell the stock of the company for stock of the buyer. You exchange your stock in your current company for stock in the buyer, and you become a shareholder in the buyer's company.
3. Sell the company's assets for cash. You would remain a shareholder in your company, but now it would own only cash; the next step most likely would be to liquidate your company.
4. Sell the company's assets for stock of the buyer. You would remain a shareholder in your company, but now it would own only stock in the acquiring company; the next step most likely would be to liquidate the company, in which case you would become a shareholder in the acquiring company.
5. Engage in an Initial Public Offering (IPO). You would remain a shareholder in your company, but it would become a publicly-traded company, and your ownership percentage would become quite smaller.

### LIABILITY EXPOSURE

Your business likely has exposure to liabilities, which might include contractual obligations, potential litigation exposure, potential environmental liability exposure,

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unpaid taxes, etc. Some of these may be known and quantified, but some may not have yet come to light. One important issue to address in the sale of your business is who will bear the burden of any such liabilities that are not yet known but relate to current circumstances. The form of sale will be an important factor.[1] In general, this issue of liability exposure can cause buyers to prefer to buy assets and sellers to prefer to sell stock.

The following is a general summary of liability exposure issues; you should consult with your attorney to determine who would bear the burden of a current business liability that does not come to light until after the sale.

1. Sell the stock of the company for cash. Generally, a sale of stock would result in the same business continuing with new owners/shareholders. Generally, the new owners of the business would bear the burden of liabilities going forward, even if related to past events. This would be the case not because the new owners/shareholders would be personally liable but rather because the business' liabilities would affect their investment. However, the purchase and sale agreement can have provisions that might require you as the selling shareholder to bear the burden of some or all liabilities that become known in the future but relate to events that occurred prior to the sale.

2. Sell the stock of the company for stock of the buyer. You would remain an owner of the continuing/acquiring company and as such would bear (via your investment) a share of the burden of liabilities occurring in the future, with the other owners. Again, however, the purchase and sale agreement might have provisions that would require you as the selling shareholder to bear the burden of some or all of the liabilities that become known in the future but relate to events that occurred prior to the sale.

3. Sell the company's assets for cash. This highlights a significant difference between an asset sale and a stock sale. In general, if you sell the assets for cash, your business remains as a business owned by you, albeit with only cash as an asset. As such, your business (and therefore your investment) would remain exposed to any business liabilities that become known in the future even if related to past events.

4. Sell the company's assets for stock of the buyer. This would be similar to #3. In general, if you sell the assets for stock, your business remains as a business owned by you, albeit with only stock as an asset. As such, your business (and therefore your investment) would remain exposed to any business liabilities that become known in the future even if related to past events.

5. Engage in an IPO. You would continue as a shareholder in the same company, though now it would be publicly traded. As such, you would bear the burden of a share of liabilities, with the other owners.

## FEDERAL INCOME TAX PLANNING: COMPETING INTERESTS OF BUYER VS. SELLER

There are obvious examples where what you want as a seller is in direct contrast to what the buyer wants. One obvious example is the price; as seller you want a higher price, and the buyer will want a lower price. However, there are much less obvious examples in the income tax world where an issue can be addressed in a way that has advantageous tax results for the seller but disadvantageous tax results for the buyer (or vice versa). Being aware of these competing tax rules can help you better address the issues. Here are some examples.

From the buyer's perspective, it is usually best for tax purposes if a payment can be deducted currently. If it can't be deducted currently, the next most favorable status would be a payment that leads to a depreciation or amortization deduction over a certain number of years. The least-preferred tax result for the buyer would be a payment that cannot be deducted and cannot be depreciated. For example:

- Payments from the buyer to the seller for continued consulting services are generally deductible (subject to certain limitations);
- Payments from the buyer for depreciable assets such as a building are not fully deductible immediately but rather would be depreciated over several years;[2]
- Payments from the buyer for non-depreciable assets (e.g., stock or unimproved land) are neither deductible nor depreciable; such payments simply represent the buyer's cost basis, which would reduce gain if that asset were ever sold in the future.

From the seller's perspective, it is usually best for tax purposes if a payment is taxed as long-term capital gain. The next favorable status would be a payment for a depreciable asset, which often is taxed partly as capital gain and partly as ordinary income (called "recapture.") The least-preferred result for the seller would be a payment taxed as ordinary income. For example:

- Payments from the buyer for stock or land held for investment would be taxed as long-term capital gain if held for more than one year at the time of sale;
- Payments from the buyer for depreciable assets such as a building are (in general) taxed partly as capital gain and partly as "recaptured" ordinary income. Depending on the particular facts, there might be a tax rate imposed on the recapture income that is lower than the usual tax rate on ordinary income;
- Payments from the buyer to the seller for continued consulting services are taxed as ordinary income.

Notice that this list for the seller is in reverse order from the list above for the buyer. That is, what is generally best (for tax purposes) for the buyer is generally worst (for tax purposes) for

[1] It is assumed that your business is organized as an entity that would limit your personal liability so that your non-business assets are not at risk. Rather, the issue being considered here is the risk that your business wealth remains exposed.

[2] However, subject to limitations, a certain amount of capital expenditures might be expensed (deducted) under Section 179 of the tax code, and an additional amount might be deducted as "bonus depreciation."

the seller, and vice versa. This is a competing tension built into the tax code, and it can be very helpful to understand how a particular payment structure will affect the buyer or seller for tax purposes.

## FEDERAL INCOME TAX CONSEQUENCES TO THE SELLER: MANY TYPES OF PAYMENTS

The sale of your business can generate payments from the buyer for many different reasons, and therefore many different federal income tax rules might be triggered. Here is a general summary of some of the many types of payments and their federal income tax consequences.

Payments for stock. Payments for stock would be taxed as capital gain to the extent the payments exceed your basis in the stock. In general the maximum federal long-term[3] capital gain rate is 15% in 2022, with the rate rising to 20% if taxable income exceeds certain thresholds (in 2022: $517,200 for married filing jointly; $459,750 for single filers). Special federal income tax rules might allow for more favorable tax treatment. We have a separate Wealth Strategy Report: *Special Income Tax Provisions for Business Owners*.

Payments for assets. In general, gain from the sale of business assets would be taxed as capital gain to the extent the payment exceeds your basis in the asset. To the extent your basis exceeds the payment, you would have a capital loss. If an asset has been depreciated, this general rule would be subject to the special recapture rule described in the following paragraph.

Depreciation recapture. Certain business assets can be depreciated, which entitles you to a deduction but also lowers your basis in the asset. Gain on the sale of such an asset can have some of the gain that is attributable to prior depreciation "recaptured" and taxed at rates higher than the capital gain rate. In some cases, depreciation recapture can be taxed as ordinary income, which is taxed as high as 37% in 2022 (plus an additional 3.8% if it constitutes "net investment income" for purposes of the 3.8% Medicare surtax).

Related party rules. Certain rules reduce some of these beneficial tax rates/rules if the sale is to a "related party," a defined term[4] that in general means a family member or a related entity. Two of these special rules are:

- Gain from sale of depreciable property between certain related parties. Under Section 1239 of the tax code, if depreciable property is sold to a "related party," then the gain is taxed fully as ordinary income rather than capital gain.
- Loss on sale of property to a related party. Under section 267 of the tax code, if property is sold to a "related party" and there is a loss on the sale, no deduction is allowed to the seller for the loss. (The transferee can use this disallowed loss to reduce future gain on sale.)

[3] "Long-term" means the stock has been owned more than one year.

[4] The two tax sections referred to, Section 1239 and Section 267, each has its own definition of "related party."

Built In Gain (BIG) Tax. In the case of an S corporation that converted from a C corporation, gain on the sale of an asset by the corporation within 5 years after such conversion can be subject to a second, corporate-level tax, known as the "Built in Gain" (BIG) tax.[5]

Installment sale. An installment sale is a sale of assets where the payments from the buyer are to be made over multiple years. In general, the gain from an installment sale is reported and taxed ratably as the payments are made each year, rather than all upfront. However, there are several exceptions to this general treatment. We have a separate Wealth Strategy Report: *Installment Sales*.

Covenant Not to Compete. Often times the sale of a business can include paying the seller not to compete for a period of time. In general, payments made to the seller in return for the agreement not to compete are taxed as ordinary income, not capital gain.

Retention Agreement/Consulting Agreement. Often times the sale of a business can include paying the seller to remain employed for a while as a "consultant". Such payments are compensation and are taxed as ordinary income.

Tax-free acquisitions. If the acquiring company pays for stock or assets with its own stock, that might qualify as a tax-free reorganization under the federal income tax code if certain conditions are met. Such tax-free reorganizations involve very complicated tax rules that are beyond the scope of this summary.

Other payments. There are many other forms of payment, and it is not always easy to determine how a payment is to be taxed. Depending on the terms of the agreement, payments may be considered payment for stock, which in general would be capital gain. Alternatively, payments may be more accurately described as for services, which in general would be ordinary income. You should consult with your tax advisor.

## RETIREMENT PLANS

Depending on the structure of the purchase, your company's retirement plans might be unaffected or they might be distributed. Planning with retirement plans can raise important income tax issues, and you should involve your financial and tax advisors early in the process so that opportunities are not missed.

## GIFT AND ESTATE TAX PLANNING

A sale of your business can present significant opportunities for gift and estate tax planning, both for family wealth transfer and for charitable planning, both discussed below.

Some of the planning ideas discussed below are better if implemented after the sale. However, several techniques should be implemented before the sale. Again, it is important to involve your financial and tax advisors early in the process so that opportunities

[5] Under legislation passed in December 2015, the 10-year period that was in the original statute, and which has been changed several times in recent years, was permanently reduced to a 5-year period.

are not missed; it is possible to wait too long, in which case a useful planning technique can become much less useful or even completely unavailable.

### Family wealth transfer planning

There are many ways to engage in wealth transfer planning for the wealth represented by your closely-held business. This can cover a spectrum of techniques, from (i) something as straightforward as an outright gift of the company stock to an adult child that qualifies for the $16,000 annual gift tax exclusion, to (ii) a Grantor Retained Annuity Trust (GRAT) funded with company stock (and several other equally sophisticated techniques).[6]

In the case of a sale of your company, you may have a choice to (i) make wealth transfers of stock in your company before the sale, or (ii) make wealth transfers after the sale. The structure of the sale will dictate what you could transfer after the sale. For example, if you are selling your stock for cash, then any post-sale wealth transfer would be of the cash proceeds.

For most of these wealth transfer techniques, it is important to implement the wealth transfer technique well before the sale occurs, for at least two reasons.

The first reason is valuation. Generally, one would expect your wealth to increase as a result of the sale. Therefore, a gift of your company stock done before the closing could have an appraised value less than the value you receive from the sale. Therefore, gifting the stock before the closing can be more gift-tax efficient. However, in general, the nearer the gift is done to the closing, and the more certain the closing is at the time of the gift, the harder it can be to get the benefit of this type of lower valuation. Therefore, it is best to make the gift sooner, which carries the risk that you might make a gift and the sale might not close.

The second reason that it is often better to implement family gifts well before closing involves minority discounts. For gift tax purposes, the fair market value of shares in a closely held company is best determined by a qualified independent appraiser. After determining the fair market value of the company, the independent appraiser typically performs an analysis to arrive at the fair market value of the shares being gifted. Often the fair market value of these shares will be lower than the fair market value of the same percentage of the underlying assets held in the company, due to two common discounts—a minority interest discount and a lack of marketability discount.

Generally, the minority interest discount accounts for the limited control or influence inherent in the transferred shares (assuming they constitute a minority interest); the lack of marketability discount accounts for the lack of a public market for the transferred shares. Both of these discounts might be appropriate for valuing shares in your closely held business before the closing, but one or both might become inapplicable after the closing.

For both of these reasons, it can be important to implement wealth transfers to family well before the closing.

### Charitable planning

For charitable planning, depending on the structure of your deal and the particular charitable technique, it might be important to implement the technique well before the closing, or it might be better to postpone the charitable gift until after the closing.

For example, assume the structure of your sale is a cash purchase of your stock, and you will be incurring capital gain. In that case, you might want to consider, as part of your charitable planning, a Charitable Remainder Trust (CRT). A CRT could allow you to fund a trust and have the trust (rather than you) sell the stock without incurring capital gain. The details of a CRT are discussed in our Wealth Strategy Report: *Charitable Remainder Trusts*.[7]

However, if the CRT is funded with your stock when the closing is not subject to any significant contingencies and therefore, as a practical matter, is certain to happen, then you (not the CRT) could be taxed on the gain anyway, defeating the income tax reason for funding the CRT. This shows how important it can be to involve your financial and tax advisors early in the process so that certain planning opportunities like this are not forfeited due to delay.

As an example at the other end of this charitable planning spectrum, assume you are to sell your company to a publicly-traded company in a stock-for-stock tax-free exchange, after which you will own stock in a publicly traded company. You would like to make an outright gift to charity of some of your stock. In this case, waiting to make the charitable donation until after the closing might provide a better tax result for at least two reasons. First, if the value of the stock is expected to increase, then waiting until after the closing could provide you with a higher charitable income tax deduction. Second, if you are donating to a private foundation, the tax rules are more generous if the stock being donated is publicly traded.

## POST-SALE PLANNING

### SEC requirements

Depending on the structure of the sale of your company, if you end up as a shareholder of a publicly-traded company, which could subject you to certain Securities and Exchange Commission (SEC) regulations. These will limit the extent to which you can sell the publicly-traded shares.

### Lock-ups

Depending on the structure of the sale of your company, you could become subject to a contractual “lock-up,” which would prohibit your sale or transfer of your stock for a certain amount of time following the closing. You should understand the extent of such

[6] We have summaries of these various estate planning techniques. If would like to receive them, please ask your Private Bank advisor.

[7] Although the CRT would not incur capital gain, as explained in the summary, distributions to the beneficiary over the term would be taxable to the beneficiary under the “tier” system applicable to CRTs.

lock-up restrictions. For example, does it prohibit only sales, or does it also prohibit gifts to family and charity?

### Hedging issues

Depending on the structure of the sale of your company, if you end up as a shareholder of a publicly-traded company, you could have significant wealth the value of which will fluctuate with the market. There are various hedging techniques that could address your downside risk from this. However, your ability to engage in a hedging transaction might have to be coordinated with the other restrictions mentioned above—SEC restrictions and/or a contractual lock-up. Therefore, if hedging will be a concern for you, you should discuss with your attorney how the terms of the sale (e.g., negotiating lock up limitations) might affect your ability to hedge.

## STATE INCOME TAX PLANNING WITH A DELAWARE TRUST

If you are contemplating the sale of your stock in your company, first contributing the stock to an irrevocable Delaware trust (assuming that would be consistent with your estate planning goals and assuming the gift tax consequences are acceptable) might minimize state income taxes on the subsequent sale. This planning idea is discussed further in our Wealth Strategy Report: *Delaware Trusts and State Income Tax Planning*.

## OTHER STATE LAWS

Most of the matters discussed have involved federal laws. A sale of your company will likely trigger important state law considerations, and therefore it will be very important for you to consult with your attorney in order to understand these consideration.

**— National Wealth Strategies, Chief Investment Office**

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