

VIEWPOINT

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REDUCE YOUR TAX BILL BY MILLIONS ON THE SALE OF YOUR BUSINESS

By Jamie Grant

There's no avoiding death and taxes, so it's prudent to have a plan for both. Not surprisingly, preparing for the sale of a business presents many of the same challenges as estate planning, and, in fact, the two processes are intertwined. If you plan to die with millions in the bank, you should plan for your estate to pay millions in taxes. But by planning ahead, you can transfer some of the value in your business to your heirs or to a beloved charity, and eliminate a significant portion of the taxes.

For someone who has built and managed a successful business over many years, the very idea of "selling" is fraught with emotion and uncertainty. Many business owners wait until an offer is on the table before they begin to think about how to handle the proceeds. The problem with this passive strategy is that once a price has been established, the options for minimizing the tax impact are significantly reduced.

NOTE TO SELF: YOU CAN'T TAKE IT WITH YOU

Everyone's situation is different. You may be looking forward to a lavish retirement (certainly you've earned it), or you may choose to maintain your current lifestyle during your retirement. In practice, if the annual income from your investments will exceed your annual expenses in retirement, you should have a plan for what to do with the additional proceeds of a sale. Since you can't take it with you, you should consider whether it is advisable to transfer some of the value to loved ones or to a charitable trust. With a well structured

WHY THIS MATTERS:

- *Effective wealth management planning can save you millions in taxes on the sale of your business.*
- *Wealth management tools not only lower your post-sale tax bill; they also provide an attractive option for inter-generational wealth transfer.*
- *Even if a business sale is several years down the road, you should start planning now because some tax-savings options require a year or more to put in place.*

plan, you can avoid paying any taxes at all on a significant portion of the proceeds, whereas if you plan to keep the proceeds and then make these transfers upon death, the value will be diminished by corporate profits tax, capital gains, and federal and state estate taxes (the "death tax") that could exceed 50 percent.

Among the factors that impact decision-making are your age, post-sale earning plans (are you going to continue to work or are you retiring), your family situation (do you have children, what are their ages, and what is your philosophy about inherited wealth), other assets you have (is the business your chief asset or have you accumulated other wealth that can help fund your future lifestyle), and your philanthropic interests.

THE COSTS OF PUTTING OFF PLANNING

Careful planning, unfortunately, is not always the norm. Quite often we meet business owners who have not done the appropriate wealth planning even though they intend to sell their companies in the near future. Delaying the necessary planning may take some of the most effective tools for lowering your tax burden off the table. Many tax-saving methods need to be considered two or more years in advance of a business sale. (See Glossary on page 4 for definitions of common tax avoidance and wealth transference tools.)

Among the business-related issues that require long-range planning to minimize the tax burden associated with a business sale is the corporate structure (C-Corp, S-Corp, LLC, etc.) and the type of transaction (sale of stock versus sale of assets). Each of these can have a significant impact on the after-tax proceeds to shareholders. One type of corporate structure can add as much as 30 percent or more to your tax burden when compared with another structure. Obviously, changing a company's structure cannot happen overnight.

"We advise people to start at least two years in advance for tax planning purposes," said Roy Ballentine, president of Ballentine, Finn & Company, Inc. "For tax planning purposes, it's best if a reasonable amount of time elapses between the transfer of a business interest to a family member and the actual sale of a business.

"Starting even earlier would be advisable because when we're able to get involved three or more years ahead of time, there are often things related to the management and financial structure of the business that can be worked on that will enhance the marketability of the company and enhance its value," added Ballentine. "For example, ideally our firm and an investment banking firm like Mirus would start a relationship with someone who is planning to sell a business five years later.

The client winds up with the perfect combination of business advice and personal financial advice to position the business for sale and to get the person's balance sheet in shape for whatever outcome the person wants to have." (See July '06 Viewpoint: "Preparing a Business for Sale: Increase Your Value by Starting Now.")

Ballentine cited an example of a Mirus client who owned an S corporation. "One of the first things we did was transfer 5 percent of the stock to a trust for their children," he explained. "The gift at that time was valued at about \$600,000. The gift was subject to a discount because it was a closely held company and this was an illiquid, non-voting minority stake. But with changes that were made at the company over the next three years, its condition improved considerably. At the time of the sale three years later, the trust ended up being worth \$3 million."

The benefit here was that the value of the initial transfer fit easily within the client's \$1 million gift tax exemption, yet the children received \$3 million. If the business owner had waited until after the sale to transfer \$3 million to his children, the gift would have triggered about \$800,000 of gift tax. Furthermore, the trust for the children included a feature that caused the capital gain tax on the sale to be paid by the client rather than by the trust. Thus, the children's trust received its share of the sales proceeds income tax free. The payment of the trust's capital gain tax by the client is the equivalent of an additional gift to the children's trust.

	PASSIVE APPROACH (Cash Gift Post-Transaction)		PRO-ACTIVE APPROACH (Gift Given 2 years ahead of Transaction)	
	Susan Jones	Jones' Children	Susan Jones	Jones' Children
VALUE AT TIME OF PLANNING				
2007 Value of the Business	\$5,000,000		\$2,501,000	\$2,499,000
2007 Tax Basis	\$500,000		\$300,000	\$200,000
Discount for Minority Stake ³				\$749,700
Discounted Value of Gift				\$1,749,300
VALUE AT TIME OF SALE				
2010 Value of the Business	\$30,000,000		\$15,006,000	\$14,994,000
2010 Tax Basis	\$1,500,000		\$750,300	\$749,700
TAXES				
Corporate Profits Tax ¹	\$0		\$0	\$0
State Capital Gains Tax (5.0%)	\$1,425,000		\$712,785	\$712,215
Federal Capital Gains Tax (15.0%)	\$4,061,250		\$2,031,437	\$2,029,813
After-Tax Proceeds	\$25,938,750		\$12,261,778	\$12,251,972
Federal Transfer Tax/Gift Tax (45.0%)	\$5,838,553			
Net Proceeds	\$10,054,118	\$10,046,078	\$12,261,778	\$12,251,972
Tax Savings				\$4,413,553
Tax Savings as a % of Gift				36%
Assumptions: 1. As an S-Corp, there is no corporate profits tax 2. Stock Sale 3. Susan Jones and her spouse give just under 50% of the value to their two children, and therefore the value of the shares is discounted (in this case by 30%), reducing the amount subject to transfer taxes				

Exhibit 1: Case Study

COUNTING THEIR CHICKENS BEFORE THEY'RE HATCHED

The reasons people delay doing the appropriate financial planning vary, but often have to do with the very nature of the task itself. "The problem with things like estate planning is that people tend to put it on the bottom of their agenda," said Barbara Freedman Wand, Esq., a partner in the Estate Planning Group of the Boston office of Bingham McCutchen LLP and managing director of Bingham Charitable Advisors. "People get anxious talking about taxes, but they need to think of the positive rather than the negative in this situation. This is the time to create liquidity for you and your family. When your money is tied up in a business, it's more about growing the business. When you're about to sell, it's more about the future and what you want to do for yourself, your family and your community."

In our experience, some people fail to appropriately plan what to do with the anticipated wealth from the sale of their business for psychological reasons, besides not wanting to deal with a somewhat daunting subject. Some people don't want to jinx themselves by "counting their chickens before they're hatched." Still others fear disappointment; they don't want to put a plan in place that details what they'll do with the \$30 million they hope to make from the sale of their company only to have the proceeds turn

out to be only \$10 million. This becomes a self-fulfilling prophecy because by failing to plan, they virtually assure that they'll pay out a higher portion of their sale proceeds in taxes.

Some people delay because they assume this type of planning is expensive, which is not the case. The legal elements of a complex estate plan might cost in the range of \$20,000 to \$25,000 to implement, a price that is minimal when compared to the millions in potential tax savings that can be achieved. The reality is that any reason that causes you to delay doing the appropriate planning is bound to cost you money in the end.

OTHER WAYS TO GET OFF TRACK

Delaying putting the right tax-saving vehicles in place is not the only way people get off track with their wealth management planning. "Another mistake we see advisors and clients make is failing to diversify the planning across multiple strategies," said Ballentine, who points out that the various mechanisms for transferring wealth have pluses and minuses. Using a variety of tools helps compensate for the shortcomings of any individual mechanism.

CASE STUDY: TAX-SAVING OPTIONS AVAILABLE IF PLANNING STARTS EARLY

Susan Jones owns a closely held business currently valued at \$5,000,000, with just \$500k of income tax basis, structured as an S-Corp. Susan earns around \$500,000 annually from the business and anticipates selling the company in three to five years at \$30-50 million. Susan would like to transfer a significant portion of the eventual sale proceeds to her children in a tax-efficient manner that takes into consideration income taxes, gift taxes, and estate/transfer taxes.

If Susan waits until the sale is imminent, she will have a \$30-50 million asset to dispose of. If instead, as she plans for the growth of and eventual sale of the business, she also addresses her estate planning goals and puts into place one or more strategies to accomplish her goals, the result can be a successful wealth transfer to the next generation.

Exhibit I on the previous page illustrates what the impact would be if Susan were to take a pro-active approach and shift just under 50 percent of the stock to her children in 2007, rather than passively waiting until after a sale. Considering that a gift of minority or non-voting shares would be subject to a discounted value, such a gift in this case could be considered to be less than half of the \$5 million value of the business at the time of the gift.

HERE ARE SOME OF THE OTHER OPTIONS THAT SUSAN COULD CONSIDER:

1. Susan makes an outright gift of non-voting stock in the company to two or more children, as in Exhibit 1. With valuation discounts, the taxable gift may be as little as \$1.5 to \$1.7 million, well within the gift tax exempt amount for Susan and her husband, while the children will ultimately realize their pro-rata share of the sale proceeds, less capital gains tax ("net proceeds").
2. Susan transfers the stock of the company to one or more grantor retained annuity trusts (GRATs) in which she retains 5 year annuities valued at \$1,000,000 per child (or less if valuation discounts applicable). If Susan survives the five years, most of the appreciated value of the company can be transferred to children gift and estate tax free.
3. Susan sells all or a portion of the company stock to a trust for the children (Susan can choose the trustee) at a discounted price (for minority position or non-voting shares) in return for 5 year installment note(s). Susan realizes the gain on the installment sale on a deferred basis; while the trust will receive the proceeds of sale when the business is eventually sold with minimal gift and estate tax consequences.
4. If the gifts were made to a trust for the children, the trust could be a defective grantor trust for income tax purposes, which means that Susan would pay the capital gains tax on sale with respect to the shares in trust for the children. The result would mean that all of the proceeds of sale would be in trust for the children, undiminished by a tax bite, increasing tax savings.

Provided by Barbara Freedman Wand, Esq., Bingham McCutchen, LLP

Another common mistake is assuming that once you've put together your plan, you're done. "It's wrong to think of estate planning as a one-time thing that you can check off your list once you've done it," said Wand. "Just like you should go to your doctor for an annual physical even though you think you're healthy, you should also periodically review your estate plan. Over the past several years, there have been federal and estate tax changes that can have a significant impact not just on taxes but also on who gets what.

"Also, people's thoughts about wealth vary over time and their total assets also change, so you need to take a fresh look at your plan," she added. "For example, if you put together your plan when your children were very young, by the time they're in college, your ideas about how soon they should have access to wealth may have changed. Also, your opinion of how much you want to leave to children or to charity may change over time."

When it comes to thinking about the next generation, Ballentine said that one of the mistakes he sees is failing to prepare the next generation adequately for whatever financial responsibilities they're going to have. "We began to notice years ago that our clients were not paying enough attention to preparing their heirs for the management of very substantial amounts of wealth," he said. "We have engaged a wealth psychologist who works with clients on the psychology of money and the impact of wealth on family dynamics."

"More so than ever in the past, there is now more wealth

creation where people go from zero to 60 very quickly," said Wand. "In a lot of these families, there's no inherited wealth, so there's no context for this new wealth. We work with clients on what are the various ways of approaching this with your children."

LONG-TERM THINKING: A NECESSITY

Finally, it's important to recognize that current longevity figures make it likely that you'll live a long time after the sale of your business, even if you wait until you're 65 to do the deal. A 65-year-old man has a 50 percent chance of living to age 85 and a 25 percent chance of living past age 92. Women, on average, live even longer, and a 65-year-old married couple has a 25 percent chance that at least one spouse will live beyond age 97.

This is one more motivation for assembling a team of professionals to help you with the wealth management needs that will accompany your business sale. While it may seem tedious or unnecessary at age 40 to begin planning how to minimize your tax burden when you sell your business down the road, it's never too soon to start. Carefully evaluating your post-sale financial objectives, including what type of lifestyle you wish to maintain, how much wealth you want to transfer to loved ones, and what societal impact you want to have through charitable giving, is some of the most important work you can do for yourself and your family.

GLOSSARY

Here are some commonly used strategies you'll be introduced to when you embark on a plan to shelter the proceeds of a business sale from taxation and transfer wealth to heirs and/or charities. In addition to these tools, when evaluating what strategies are best for your situation, don't forget the power of direct gifts to loved ones or charities. Simple to put in place, such gifts are an effective tax-savings tool.

- **Grantor-Retained Annuity Trust** – With a GRAT, you transfer property to an irrevocable trust for a set period of years (the minimum is two). In return, you receive fixed payments based upon the initial fair market value of property. At the end of the trust, the assets flow to the beneficiary tax free, even if they have gained in value.
- **Charitable Remainder Trust** – With a CRT, you place assets in a trust for a charity (or charities) and receive income of a fixed amount of at least 5% but not more than 50% of the initial fair market value of property placed in the trust, for life or for a period of up to 20 years. At your death (or the death of other income beneficiaries you have named) the charity receives the remainder of the trust.
- **Sale to an Intentionally Defective Grantor Trust** – Although the name sounds bad, this is actually a very useful strategy. In essence, it is a grantor trust for income tax purposes, but a completed gift for estate and gift tax purposes. You fund the trust through gifts over a period of years and then use that funding to purchase your company stock for the trust. You take back a combination of cash and a note. The IRS sets a minimum rate of interest that the note can earn and everything above that stays in the trust, making it a very effective estate building mechanism.
- **Donor Advised Funds (also known as charitable gift funds)** – With a donor-advised fund, you set up a charitable account with a qualified public charity and then are able to recommend (but not control) how the money is given to various charities that you select. In effect, such accounts are mini-private foundations that are free of the costs associated with establishing your own foundation. The popularity of such funds has made donor advised funds operated by mutual funds companies among the largest and fastest growing public charities in the country.

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