

Passing the Torch: Issues for Successful Business Succession Planning

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GOALS OF ANY BUSINESS SALE IN A FAMILY SETTING

- “Freeze” or reduce the value to be included in the Seller’s Estate.
- Transfer the business to the appropriate family member.
- Satisfy the Seller’s need for proceeds from the sale.
- To the extent the Seller requires, secure the payments to the Seller.
- Minimize any adverse Income Tax Consequences

PAYMENT OPTIONS

- CASH SALE
- TRADITIONAL INSTALLMENT SALE
NOTE
- SELF-CANCELLING INSTALLMENT
NOTE
- PRIVATE ANNUITY
- COMBINATION

INSTALLMENT SALE ISSUES

- Not applicable to Inventory or other Ordinary Income Property, in most cases.
- Any Recapture of Depreciation must be reported in year of sale.
- A Taxpayer may elect out of Installment Sale reporting.
- Section 1274(d) generally determines the minimal interest rate.

INSTALLMENT SALE ISSUES

- The disposition of an Installment Sale Obligation triggers gain equal to the excess of the amount received over the basis.
- A cancellation of the Installment Obligation in favor of a related Obligor, triggers the gain not yet reported.

INCOME IN RESPECT OF A DECEDENT (IRD) - Section 691

- Generally, assets receive a new basis at the death of a decedent.
- A major exception is Income in Respect of a Decedent (IRD). This is an item of income received post-death, that was not taxable during life to a cash basis taxpayer.
- If a Taxpayer must include IRD, the recipient may be entitled to a deduction of the Federal Estate Tax due thereon, per Section 691(c).

INCOME IN RESPECT OF A DECEDENT (IRD) - Section 691

(Continued)

Examples of Income In Respect of a Decedent include:

- Qualified Plan and IRA Distributions
- Interest Income Accrued at Death
- Installment Sale Proceeds
- Deferred Compensation Unpaid at Death

TYPICAL ORDINARY INCOME TAX CONSEQUENCES

Cash Sale	N/A, unless Partnership or Asset Sale
Traditional Installment Sale	Interest Income
SCIN	Interest Income
Private Annuity	Amount in excess of Investment

COMPARISONS: CAPITAL GAIN (Realized During Lifetime of Seller)

- Cash Sale Report in Year of Sale
- Traditional
 Installment Sale Report as Principal
 is Received
- SCIN Report as Principal is
 Received
- Private Annuity Report in Year of Sale

COMPARISONS OF CAPITAL GAIN, POST-DEATH

- Cash Sale N/A
- Traditional Installment Sale Capital Gain not yet reported (IRD)
- SCIN Same as Traditional – but include immediately on Form 1041.
- Private Annuity N/A (Possibly a Loss on Final Form 1040)

Cash Sale

PROS:

- No question for Seller re: payment.
- No concern for Buyer of meeting Seller's performance requirements
- Seller's Capital Gain is taxed at current rates

Cons:

- Often difficult to achieve
- Typically requires outside funding
- Lender may impose its own performance standards

Traditional Installment Sale

- Pros:
- Allows business to self fund the purchase
- Does not tie up other cash
- Applicable Federal Rate of Interest may be desirable
- Interest should be deductible by Buyer
- Buyer's basis is principal amount of Note
- Cons:
- Requires the Seller to realize Capital Gains taxation
- Ties the Seller to the business, indirectly
- Forces all Capital Gain to be realized
- Not all gain can be deferred (Asset Sale)
- State Income Taxation may not follow Federal

Self Canceling Installment Note

- Pros:
 - Same as traditional Installment Note
 - May not require full payment
 - No asset to include in Gross Estate at death of Seller
 - Buyer's basis is principal amount of Note, not what is actually paid
- Cons:
 - Same as traditional Installment Note
 - Requires either an “interest” premium, or a “principal” premium.

Private Annuity

- Pros:
- Allows payments to be spread out over the Seller's lifetime
- Seller can't outlive payments
- No asset to include in the Gross Estate
- Cons:
- Gain is taxed "up-front" (post October 2006 sales)
- No deduction to Buyer for Interest
- A short life may result in a bargain sale
- Buyer's basis "floats"

EXAMPLE

- Assume the following:
- Sale Price: \$2.1 MM
- Basis \$.1 MM
- Gain \$2.0 MM
- Buyer Pays \$100,000 at closing
- Buyer gives Note for \$2,000,000 for 10 years, plus interest.

Comparison of Traditional Installment Sale vs. SCIN

• Note Principal:	\$2,000,000	
• Interest Rate	4.1% (or 6.133%)	
• Term	10 Years (or Sooner)	
• Basis is	\$95,238 (\$100,00 less \$4,762)	
• Annual Payment	<u>Traditional</u> \$247,811	<u>SCIN</u> \$273,451
• Total Payments (Full Term)	\$2,478,109	\$2,734,508

Comparison of Traditional Installment Sale vs. SCIN

• Note Principal:	\$2,000,000	
• Interest Rate:	4.1% (or 6.133%)	
• Term:	10 Years (or Sooner)	
• Basis is:	\$0	
• Annual Payment:	<u>Traditional</u>	<u>SCIN</u>
	\$247,811	\$273,451
• Assume death in year 6		
• Interest Income Reported:	\$ 339,173	\$ 514,972
• Capital Gain Reported:	\$ 952,269	\$ 906,935
• Capital Gain <i>to be Reported</i> :	\$1,047,731	\$1,093,065
• Federal Estate Inclusion of Balance:	\$1,100,118	\$ 0

COMPARISON OF SCIN VS. PRIVATE ANNUITY

Self Canceling Installment Note

- \$273,451 Annual Payment at 6.133%
- Buyer will not make more than 10 payments

Private Annuity for age 70 Seller, Section 7520 rate at 3.2% in October 2009

- \$195,802 Annual Payment
- No limit on number of payments Buyer will make. After 15.5 payments, Buyer overpays.

Comparisons of Payment Strategies

Federal Estate Tax Inclusion Amount

- | | |
|--------------------------------|---------|
| • Traditional Installment Sale | Balance |
| • SCIN | Nothing |
| • Private Annuity | Nothing |

Comparisons of Payment Strategies

Capital Gain Taxation During Lifetime

- | | |
|--------------------------------|-----------------|
| • Traditional Installment Sale | As Received |
| • SCIN | As Received |
| • Private Annuity | In Year of Sale |

Comparisons of Payment Strategies

Capital Gain After Death

- | | |
|--------------------------------|---------------------------------------|
| • Traditional Installment Sale | Taxable As Received |
| • SCIN | Taxable in Year of Death on Form 1041 |
| • Private Annuity | N/A-Possibly a Loss |

Comparisons of Payment Strategies

Buyer's Income Tax Basis

- | | |
|--------------------------------|---|
| • Traditional Installment Sale | Principal
<i>Amount Paid</i> |
| • SCIN | Principal Amount
<i>of Note</i> |
| • Private Annuity | Basis "Floats".
Ultimately
Equals
<i>Amounts Paid.</i> |

Comparisons of Payment Strategies

Buyer's Deduction for Interest Paid:

- | | |
|--------------------------------|---|
| • Traditional Installment Sale | Interest Actually Paid* |
| • SCIN | Interest Actually Paid* |
| • Private Annuity | No Deduction for Ordinary Income Portion. |

* Assumes Qualifies as Investment Interest or on Schedule E.

Federal Income Tax Issues-Sale of Corporate Stock

- Entity Purchase
- For Corporations, A dividend may result, if the distribution does not satisfy the Section 302 redemption requirements. Attribution is a major concern. Even if no E&P, dividend treatment means no installment sale.
- Cross-Purchase
- In a corporate setting, the Buyer assumes all the tax “baggage” inside the entity.
- In a corporate setting, the Seller has no redemption concerns.

Federal Income Tax Issues - Partnerships

Entity Purchase

- Generally amounts received upon a partner's retirement or death are in exchange for a Capital Asset, except to the extent of the Seller's share of Inventory [Section 751(b)].

Cross-Purchase

- Generally, amounts received are in exchange for a Capital Asset, except to the extent the Seller is paid for Section 751(a) "hot assets", which are Unrealized Receivables and Inventory. Note that "Unrealized Receivables and Inventory" is a broad category of assets.

ENTITY DIFFERENCES: CONSEQUENCES POST-DEATH

- Inside vs. Outside Basis
 - The Buyer's income tax basis is different than the entity's basis in its assets, unless the entity is taxed as a Partnership and a Section 754 election is made.
- Pro-Rata Distribution Rights
 - In an S Corporation, distributions must be made in proportion to actual share ownership, regardless of voting rights.

ENTITY DIFFERENCES- LIQUIDATION

- C-Corporation
Generally, timing of Distributions is not an issue.
- Gains and Losses inside Entity do not “pass-through” directly
- S-Corporation
- Timing of Distributions is significant
- Gains and Losses inside entity “pass-through” directly, so income without cash can cause a mismatch of income .

Section 754 Election

- Applies only to entities taxed as Partnerships, not to Corporations.
- Applies only upon the transfer of an interest in a partnership by sale or exchange, or upon the death of a partner.
- Applies only to the transferee partner.
- Effectively allows the “outside basis” to equal the “inside basis” for the affected partner.