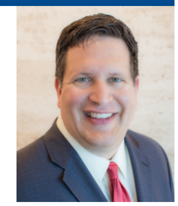
9237 Ward Parkway, Suite 320 | Kansas City, MO 64114

21 Key Rules, Concepts, and Strategies for Closely Held Business Owners Selling Their Business with a Concern for Taxes and Estate Planning



Peter Vrooman, CFA®, CIMA®, CRPC®, CAIA®
Partner, Wealth Advisor
Fundamental Choice Portfolio Manager
816-601-1152
peter.vrooman@svwealthadvisors.com

Jonathan Sarver, CPWA®
Partner, Wealth Advisor
Fundamental Choice Portfolio Manager
816-601-1151
jonathan.sarver@svwealthadvisors.com

VALUATION METHODOLOGIES

#1

Asset-Based Valuation

This valuation method established the business valuation based upon the value of the business assets without regard to the projected earnings power of the company. Often this valuation method is used when 1) the business is a REIT or investment holding company, 2) the value of an existing business exceeds its liquidation value, yet there are negligible earnings, or 3) a business where the earnings are based upon personal goodwill of the operators and therefore is not transferable to the buyer of the business *(Staff Writer, 2017).*

#2

Capitalized Economic Income Approach to Valuation

$$\frac{\text{Economic Income or (“Cash Flow”)}}{\text{Capitalization Rate or (Discount Rate - Growth Rate)}} = \text{Value}$$

OR

$$\frac{\text{Cash Flow}}{\text{(Discount Rate - Growth Rate)}} = \text{Value}$$

Example:

2.5 million Annual cash flow from a closely held business with a 6% growth rate and a 15% discount rate

$$\frac{2{,}500{,}000.00}{(15\%-6\%)} = \$27{,}777{,}777.80$$

(Staff Writer, 2017)

#3

Publicly Traded Company Method of Valuation

First, identify similar publicly traded companies in the same industry and utilize their current daily stock prices. For example, an engineering firm may use Flour, Jacobs Engineering, KBR, AECOM, and Emcor as a group of publicly traded engineering firms to benchmark a closely held business against for valuation. Price to book value, price to cash flow, price to earnings, and price to sales may be used as valuation metrics for this basket or group of stocks to determine a fair market value for a closely held business. Both the mean and median figures for all of the metrics can be used to determine the proper benchmark multiples to value the closely held business *(Staff Writer, 2017).*

#4

Accounting and Financial Data Adjustments

Valuations can be adjusted up or down based upon debt levels or cash on the balance sheet. Also whether a company is using FIFO or LIFO accounting can merit higher or lower valuations. In addition, valuation should take into account for the cancellation of bad debts or worthless assets. Furthermore, different methods of depreciation will have an effect on the valuation. Given the multiple factors of financial and accounting adjustments listed above, as well as additional ones, owners of private businesses should consult an investment bank or valuation specialist for a fairness opinion or qualified appraisal prior to a sale *(Zipse, 2017).*

#5

Discounts and Premiums

All else being equal, arguments can be made to apply a discount for a "minority interest" and a premium for a "controlling interest," because the amount of control a person or entity has over a business can have a profound effect upon its value to that person or entity. This is discussed again in the discussion of Family Limited Partnerships *(Zipse, 2017).*

#6

Acquisition or Comparable Transaction Method

While this method is similar to the publicly traded company method, rather than using current stock prices of publicly traded companies, prices of acquired companies are used instead. Again, price to earnings, price to book, price to cash flow, and price to sales, as well as other metrics that may be more industry specific may be used. However, under this method the prices of acquisitions and the multiples for different valuation metrics are used as a benchmark to determine the price of the closely held business *(Staff Writer, 2017).*

#7

Section 338(h)(10) election

This is an election made and agreed upon by both the buyer and the seller for the stock sale of an S Corporation. This election allows the buyer to obtain the same tax treatment as if the buyer had purchased the sellers assets and the buyer can then receive a stepped-up cost basis in the seller's assets and take advantage of depreciation, in essence creating greater after-tax cash flow and raising the value of the business. This allows the stock buyout to be treated as an asset purchase for tax purposes. A study conducted by Professor Merle Erickson of the University of Chicago found that due to the 338(h)(10) election, the sale of S Corporations produced between a 12% and 17% greater deal price than similar C Corporation sales. While it is common practice for the seller and the buyer to split or share the tax savings, there is no precise formula that dictates that it needs to be 50/50 and an uninformed seller may not be compensated for making the 338(h)(10) election if the buyer takes advantage of the seller's ignorance. Currently there is a 5-year waiting period from which a seller converts to an S Corporation from a C Corporation and can have the sale of the business treated as a sale of an S Corporation for tax purposes *(Nitti, 2015).*

DIFFERENT STRUCTURES FOR THE TRANSFER OF A CLOSELY HELD BUSINESS

#8

Buy-Sell Agreements

Often business owners will engage in different types of buy-sell agreements where the remaining owner(s) agree(s) to buyout the departing owner upon death, disability, retirement, and/or other triggering events. Many times these arrangements are funded by life insurance. Sometimes the buy-sell agreement will mandate an appraisal upon a triggering event such as the death of the owner.

Buy-sell agreements will be structured in three main forms: redemption, cross purchase, and hybrid. In a redemption agreement the contract is between the business and the owners, where the business itself agrees to purchase the deceased or departing owners' interest in the business using assets from the business. In a cross purchase buy-sell agreement is a contract between the owners of a business, where the remaining owners are bound to purchase the departing or deceased owner's interest from the assets of the owners themselves. A hybrid buy-sell agreement is where the owners have the right of first refusal to purchase the departing or deceased owner's share but if they do not, then the business entity is bound to buy out the interest.

According to *IRC Section 2703,* closely held business owners can establish the fair market value of a business for estate tax purposes with a buy-sell agreement, as long as the following rules are followed:

1). There is a bona fide business arrangement or a genuine business purpose.

2). It is not a scheme to transfer the business to family members or others for less than full consideration or less than fair market value.

3.) The terms are parallel to agreements made by unrelated buyers and sellers in the same type of business in a negotiated transaction where each party is looking out for their individual interest.

(Staff Writer, 2017).

#9

Private Annuities

This is an *estate freeze strategy* where the owner of a closely held business transfers ownership to a family member for the right to receive unsecured payments for the seller's lifetime. Unlike an annuity provided by an insurance company, this annuity is private because it is provided by a private party. If the present value of future payments based upon the business owner's life expectancy is equal to the value of the property, there's no gift tax incurred by implementing the private annuity strategy. Also the value of the property and potential future appreciation is removed from the business owner's estate. Proposed regulations eliminated the benefit of using highly appreciated assets, by requiring the business owner or transferor to recognize the gain when the annuity is initially set up. If the transferor or annuitant has a high cost basis (very little capital gain) this may be an effective strategy. A business owner's family will benefit greatly should he pass away earlier than his life expectancy, because the requirement to make annuity payments ceases at the death of the annuitant. The reverse is true if the business owner outlives his life expectancy and the family ends up paying greater than the fair market value for the business. Another risk is the unsecured nature of the transaction, which could give rise to the family being unable or refusing to make payments, which could cause the transaction to be considered a taxable gift rather than a private annuity by the IRS *(Hillman, 2012).*

#10

Self-Canceling Installment Notes

This strategy removes an asset and its future growth from the seller's estate. This is an estate freeze (fixes the current value of the assets for estate tax purposes) strategy which is used to transfer a business to the next generation through an installment note at a fixed price, with a specified number of payments, over a specified period of time, with a fixed interest rate and with a built-in cancellation feature should the seller die prior to the end of the term. The buyer has to pay a premium for the cancellation feature by paying a significantly higher rate of interest or a significantly higher purchase price to account for the chance the note will be cancelled should the seller pass away prior to the end of the term. If the seller does die prior to the end of the installment term, the note is cancelled and no more payments are due and the note has no value and there are no estate taxes to be paid for the note. There also is no gift tax cost during the seller's lifetime. If the seller lives through the full term of installment payments, he will receive the entire payment amount which includes a risk premium for the cancellation feature. The transaction will be found to be not legitimate by the IRS if the seller's particular life expectancy is so short that both parties demonstrate no reasonable expectation the note will be paid off *(Staff Writer, 2014).*

#11

Employee Stock Ownership Plans (ESOP)

This type of plan is used so that owners can sell their company, as a reward to retain and recruit employees or to borrow funds to make acquisitions with pretax dollars. The ownership is contributed to the employees, rather than purchased by them. This is an important distinction because it often leads to an additional retirement savings asset that similar employees in non-ESOP companies do not have. The company establishes a trust fund to deposit stock or cash for the purchase of stock, where the contributions are tax deductible. Employees vest in their stock within 3 to 6 years depending upon the plan. When employees separate from service or retire, they receive cash for their stock. The company obtains an outside evaluation of the market value of the company stock every year. The ESOP makes tax deductible contributions of both principal and interest to buy company shares or shares of an existing owner.

There are major tax benefits to an ESOP: (1). Contributions of stock, (2) cash, and (3) contributions used to pay back a loan the company set up to purchase employer stock are all tax deductible. (4) In a C Corporation, once an ESOP owns 30%

of the employer stock, the seller can defer any tax on the gain and diversify by investing in other securities. If the seller holds the securities at death the seller's heirs will receive a stepped up cost basis and taxes will never be incurred. (5) For S Corporations the amount of stock owned by the ESOP is not taxed at the federal level. There are no taxes at all on earnings of an S corporation that is completely owned by its ESOP. (6) Dividends are tax deductible. (7) Employees incur no tax upon the contributions to the ESOP retirement plan and can roll it to an IRA to defer the tax upon separation of service or retirement. Also, if a plan document allows, employees can take a distribution and pay taxes where the appreciation (net unrealized appreciation) is taxed at capital gains rates. As always a distribution prior to retirement age is subject to a 10% penalty, unless an exception applies *(Staff Writer, 2017).*

#12

Grantor Retained Annuity Trust (GRAT)

This is an estate freeze and irrevocable trust strategy where the business owner transfers the business while retaining the right to receive an annuity for a finite term of years. After the term of years is up, the business passes to the beneficiaries of the trust, typically the business owners children and is now out of the estate. If the business owner or grantor predeceases the life of the trust, all or part of the business may be subject to estate taxes as part of the business owner's estate. A fixed amount is payable annually. A zeroed out GRAT is created is when the valuation of the interest retained by the grantor is equal to the asset value or business interest contributed to the trust and earmarked for the beneficiaries. There is no taxable gift for a zeroed out GRAT but the property or business interest is removed from the business owner's estate, as long as the business owner or grantor survives the term of the GRAT. GRATs are more commonly used then GRUTs or grantor retained unitrusts *(Dungey and Dougherty, 2013).*

#13

Grantor Retained Unitrust (GRUT)

This is a strikingly similar estate freeze irrevocable trust strategy as a GRAT, but instead of a fixed amount paid annually a fixed percentage of the trust property is paid out annually and the amount of income received by the business owner or grantor fluctuates each year *(Staff Writer, 2016).*

#14

Installment Sales to Intentionally Defective Grantor Trusts

This estate freeze strategy is set up so the grantor sells his business income tax free with the potential for capital appreciation going to the trust with the children of the business owner as the beneficiaries. The appreciation of the business is removed from the business owner's estate. The grantor or business owner is treated as the owner for income tax purposes but not estate tax purposes. The grantor retains administrative powers so the trust is treated as the grantor's for income tax purposes but not estate tax purposes. Given this structure the note interest paid to the grantor is income tax free and the sale of the assets by the business owner to the IDGT avoids capital gains taxes. Basically, the arrangement is treated as a sale by the business owner or grantor to himself. The value of the trust and appreciation of the assets in the trust is removed from the business owner's estate. It is important to make certain that the trust is initially established with enough assets so the trust is considered an independent entity when the business owner sells his business or assets to the trust *(Staff Writer, 2016).*

#15

Family Limited Partnerships and LLCs as Family Transfer Vehicles

If executed correctly Family Limited Partnerships or FLPs can be used to transfer a family business to the next generation while mitigating estate taxes. Whether an FLP is allowed is based upon the facts and circumstances of each case. Examples where the government had high probability of successfully challenging an FLP included deathbed transfers, cases where the decedent still had access to the assets, and cases of personal assets that the decedent continued to enjoy the use of. The taxpayer must demonstrate a significant non-tax purpose for transferring the assets or business to the family limited partnership (FLP).

FLPs have multiple benefits:

1). Gifting assets to younger family members without relinquishing control of the assets or business.

2) Asset or Business protection from the reach of creditors.

3). Leaving assets to heirs at a discount to minimize or eliminate estate taxes.

4). Lower income taxes by transferring interests in the family limited partnership to family members in lower tax brackets, such as children.

5). Reduce gift taxes.

Two classes of shares are created: General Partner shares and Limited Partner shares. Even if the general partners own a small percentage of the FLP, they still control it, while the limited partners do not have control of the FLP *(Zipse, 2017).*

#16

FLP Discounts

Minority Interest Discount: The value of the FLP interests are valued at a discount for "minority interest." *Lack of Marketability Discount:* The partnership agreement for the FLP has clauses that prevent the sale of an interest to a non-family member. This reduces the liquidity and value of the interests and in turn reduces the estate tax liability. Although the asset values are not really depressed, the partnership interests are discounted and this discount is applied to the potential estate tax liability. Often discounts can be up to 40% or higher *(Zipse, 2017).*

ESTATE PLANNING RULES

#17

Dynasty Trusts

This type of wealth transfer strategy takes advantage of the generation skipping transfer tax exemption amount or GST tax exemption amount of $11,200,000.00 per person or $22,400,000.00 per couple to create a trust that is created to last for as many generations as allowed by state law. Often it is advised that donors to a dynasty trust focus on growth oriented investments, given the long-term nature of the trust and the purpose of the trust to grow for generations. An added benefit for generations to come is the asset protection and marital protection as well as protection from indiscriminate spending by heirs. While Kansas does not permit dynasty trusts, Missouri does allow dynasty trusts. It may make sense to choose an alternate state jurisdiction from the one the trust settlor resides in. Alaska, South Dakota, and Nevada, are among the best state jurisdictions for establishing a dynasty trust. Many states still enforce the *rule against perpetuities* which limits a present or future interest to lives existing at the time the trust or instrument is created plus a period of 21 years. According to the *rule against perpetuities,* interests must vest within the time frame. Under the Uniform Probate Code of 1990, a property interest is not legitimate, unless it will 1) vest or end within 21 years of an existing life at creation or (2) the interest vests or terminates within 90 years of its establishment *(Staff Writer, 2014).*

#18

Section 303 Redemption

This is a federal tax section that provides special tax treatment and counts a redemption of a decedent's stock in a closely held business as an exchange rather than as a dividend and therefore reduces the taxes typically to zero because the heirs receive a stepped-up cost basis in the stock at death, rather than having to pay taxes on a stock dividend distribution. A key requirement is that more than 35% of the decedent's adjusted gross estate is the stock of a closely held business. If multiple businesses are owned an aggregate of a 20% threshold must be exceeded. The purpose of this special tax treatment is the heirs of a closely held business would not be compelled to liquidate the business to pay estate taxes. The redemption must take place within 15 months of the decedent's date of death *(Staff Writer, 2014).*

#19

Section 6166 Installment Payments

This is a special section of the tax code that allows the deferral of estate tax payments. The decedent must be a US citizen or resident and the value of the decedent's ownership of a closely held business must be greater than 35% of the value of the decedent's adjusted gross estate. The estate's administrator must file a form 706 to make a timely election of section 6166. This section allows a five year deferral of estate taxes on the closely held business interest and following this deferral period the estate taxes may be paid in as many as 10 years of annual installment payments. In contrast, estate taxes due on non-closely held corporation assets are due nine months following the death of the decedent. It may be necessary to post a bond as security for the amount of deferred tax. While the IRS will levy an interest charge on the unpaid estate taxes relating to the business, the heirs can pay off the tax bill at any time without incurring a penalty. Interest payments are not estate tax deductible, or income tax deductible *(Zipse, 2017).*

TAX SAVING RULES

#20

Qualified Small Business Stock. Section 1202 Stock

This rule allows individual investors to exclude up to 100% of gain on qualified small business stock, up to 10,000,000.00 or 10 times the taxpayers cost basis in the stock, if it was issued after August 10, 1993 and owned for more than 5 years. Any gain in excess of the exclusion amount is taxed at 28%. The rule does not apply to corporate investors. The following restrictions apply: (1). the investor must have bought the stock when it was first issued. (2). the corporation's total assets, before or immediately after the stock issuance, cannot be greater than 50,000,000.00 dollars. (3). In order to be considered a qualified small business, the company must be structured as a C corporation that is engaged in an active trade or business. (1) The following types of service businesses will not be considered a qualified small business: health, accounting firms, law firms, architecture firms, consulting businesses, engineering firms, financial firms, brokers, or any business where the asset is the skill and reputation of the employees, or (2) hospitality business including hotel, motel, or restaurant, or (3) or banking, insurance, leasing, financing, investing, or farming *(Henricks, 2005)*.

#21

Section 1031 Exchange or Like-Kind Exchange

This strategy is known as a *like-kind exchange,* where the seller of trade or business property can defer the recognition of a capital gain or loss by purchasing like-kind property or in this case, trade or business property. In the case of investment property, the replacement property must be investment property. Any cash or debt relief received is called "boot" and the gain on that part of the transaction is taxed. The additional basic rules are as follows: (1). The property to be purchased must be identified within 45 days of the sale of the original property, (2). The replacement property must be bought within the 180-day limit from the sale of the original property, (3). To execute a like-kind exchange the real estate investor must trade up or make certain the replacement property is of greater or equal value to the original property, (4). The retention period of the replacement property must demonstrate a desire to hold for investment, and (5). The related party rules must be followed. This set of rules prevents an investor from taking advantage of the like-kind exchange rule by conducting an exchange with a related party *(Henricks, 2005)*.

Citations

Dungey, M., & Dougherty, J. (2013, August 5). *Trusts & Estates.* Retrieved December 27, 2017, from http://www.wealthmanagement.com/

Henricks, M. (2005, May 7). *The S-Corp Windfall.* Retrieved December 27, 2017, from http://www.chicagobusiness.com/

Hillman, J. F. (2012, July 24). *The Often Misunderstood Rule Against Perpetuities.* Retrieved December 27, 2017, from https://www.lexisnexis.com/legalnewsroom/estate-elder/b/estate-elder-blog/archive/2012/07/24/the-often-misunderstood-rule-against-perpetuities.aspx?Redirected=true

Nitti, T. (2015, October 5). *Tax Geek Tuesday: A Buyer's Best Friend — Understanding The Section 338(h)(10) Election.* Retrieved December 27, 2017, from https://www.forbes.com/taxes/

Writer, S. (2016, October 12). *How The IDGT Strategy Turns Business Stock Into A Bond For Estate Tax Purposes.* Retrieved December 27, 2017, from https://www.kitces.com/

Writer, S. (2014). Section 303: *Stock Redemptions to Pay Death Taxes.* Retrieved December 27, 2017, from http://www.accounting101.org/

Writer, S. (2017). *How an Employee Stock Ownership Plan (ESOP) Works.* Retrieved December 27, 2017, from https://www.nceo.org/

Writer, S. (2017). *Valuing A Business.* Retrieved December 27, 2017, from https://home.kpmg.com/us/en/home.html

Writers, S. (2014, January 27). *Dynasty Trusts.* Retrieved December 27, 2017, from http://blog.kylekrull.com/kansas-missouri-estate-planning/

Writer, S. (2017). *Should You Be Using a Buy-Sell Agreement to Establish Tax Value?* Retrieved December 27, 2017, from https://www.bing.com/cr?IG=008AD24F86DB4E488F939356091E2C6B&CID=1E9D8D 7BA9C666683FFF861EA86967CC&rd=1&h=cCT37ZQWZe9ZQP_9E6JWhr6E8kDuOsdgfs1P8pvqoM0&v=1&r=https%3a%2f%2fwww.withum.com%2f&p=DevEx,5065.1

Zipse, R. L. (2017). *2017 Field Guide: Estate & Retirement Planning, Business Planning & Employee Benefits.* Erlanger, KY: The National Underwriter Company.