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FOR EXECUTIVES SEEKING TO BUY, SELL, OR RECAPITALIZE BUSINESSES

Structuring An Exit

An Overview of Tax Beneficial Strategies

There are several possible ways to structure a deal to suit the needs of a seller. This document summarizes some commonly used strategies and the associated trade offs:

Installment Sale

Installment sale is a simple strategy where a part of the sale price is deferred. The deferred amount is paid to the seller in several installments over a period of time.

Some variants:

- Standard Installment Sale: Payments are spread evenly over a period of time.
- Performance Based: Payment stream is tied to metrics agreed on by the buyers & sellers
- Self Canceling Note: Payments are spread until the seller dies.

Benefits:

- Smart way to structure a sale in special situations (ex: concentrated customer base)
- Capital gains are deferred as payments are received
- Self Canceling Notes pull the future interest of the asset outside of the estate

Downsides:

- Risk of future payments
- Capital gains rates may rise in future

Where it applies:

- Seller has confidence in buyer to deliver on future payments
- Buyer requires the structure due to economic uncertainties
- Seller has captured most of the value in the upfront payments and does not mind risking the incremental money stream

Structured Sale

Structured sale is similar to an installment sale except that the payment stream is guaranteed by a third party

Benefits:

- Capital gains are deferred as payments are received
- Secured payment stream
- Payment stream can be structured in a very flexible way

Downsides:

- Capital gains rates may rise in future
- Time consuming and expensive for buyer to setup

Where it applies:

- Seller may need to substantially increase take-home dollars to make the sale happen. This tax advantageous method requires a motivated buyer to setup this plan.

1031 Exchange

Allows for a seller to roll equity and debt into a new property and defer the capital gains tax until some future sale

Benefits:

- Capital gains deferral
- Can move tax deferred dollars from active management to passive management

Downsides:

- Limited time: 45 day to identify replacement property and 180 days to close
- May not be able to find a desirable property
- Capital gains rates may rise in future

Where it applies:

Excellent technique to defer capital gains assuming availability of good investment options

1042 Exchange

Complex exit strategy where privately owned stock can be exchanged for publicly traded stock. If a highly appreciated asset is owned by a corporate entity, shares of that entity can be sold and exchanged for shares of a listed stock.

Benefits:

- Defer Capital gains tax. Exchange can be made with dividend producing Blue-Chip stocks

Downsides:

- Capital gains rates may increase in the future

Where it applies:

- Might be applicable for business-owned assets that have appreciated in value

Charitable Trusts

- This method is only applicable if the sellers have determined what they will leave to charity at death. It is possible to make a future gift to a charity in exchange for an income stream. This method allows for an income stream comparable to what is possible with direct sale of business. It is also possible to gift the income payments to charity and have the asset revert to the estate at death.

Benefits:

- Charitable Organizations do not pay capital gains tax
- Tax deduction that is some proportion of the value of the gifted property or asset
- Asset is removed from the estate for purposes of estate tax
- Asset and income stream are protected from judgments, liens and bankruptcy claims

Downsides:

- The asset reverts to charity at death of the grantor(s)

Where it applies:

- When the seller has already decided on the amount of the estate that goes to a charity

Private Annuity Trust / Deferred Sales Trust

The capital gains benefits available with a Private Annuity Trust may be discontinued. In this method: Grantor(s) establish a trust, sells the asset to the trust and the trust sells the asset to the buyer. Trust makes installment-like payments to the grantor(s) over their lifetimes. Capital gains taxes are due as installment payments are made to grantor(s). At death of grantor(s), asset passes to beneficiaries.

Benefits:

- Capital gains taxes are deferred and interest is earned on taxes not paid to government
- Trust assets can be invested in almost anything. Grantor(s) have the ability to borrow money form the trust. Trust assets can be fully withdrawn as long as capital gains taxes are paid at time of withdrawal
- Trust is held outside of the estate for purposes of estate tax and assets in trust are protected from judgments, liens and bankruptcy claims

Downsides:

- The trust needs to have a third party trustee
- Capital gains may rise in future, but the trust can be liquated as needed

Where it applies:

- The intent behind establishing a PAT should be to exchange an asset for a lifetime income, to defer capital gains taxes or to avoid estate taxes or any combination

Chak Reddy is a Mergers and Acquisitions Advisor with Elite Mergers & Acquisitions, Inc. Elite Mergers & Acquisitions specializes in selling California Central Valley businesses with revenues between $1 million and $100 million - Businesses too large for business brokers to adequately handle but too small for the national M&A firms. Mr. Reddy is a business M&A and Marketing expert, and is the chief deal maker at Elite. You can reach Mr. Reddy at 916-220-3052 or by email at creddy@elitemanda.com.

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