

PREPARING TO SELL YOUR BUSINESS

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This Article provides information on various legal issues. However, that information should not be construed as legal advice or an opinion as to particular situations or applications.

INTRODUCTION

Preparing to sell a business, whether a limited liability company, operating partnership, S corporation or C corporation, means beginning a long, complex and arduous process with advanced planning being one of the significant keys to achieve success.

For the business owners, the process involves maximizing the value of the business. Are there other reasons, such as a lack of a succession plan? Not unexpectedly conflicts among shareholders or partners can arise, particularly when one party takes a tax or economic position that is adverse to the interest of another.

THE APPRAISAL

Perhaps the beginning of the business sale process involves an ascertainment of whether the owners' anticipated economic rewards from the disposition of their long-time trade or business activity is realistic. Here, the engagement of a qualified appraiser is called for.¹ Perhaps, the seller knows the worth of his or her business better than anyone else.² The buyer would most likely predict its income flow and will base the price on discounted cash flow.³ To the extent that the business enterprise involves commercial real estate, perhaps more than one appraiser should be used, one to evaluate the business assets and a second to evaluate the accompanying real estate.

Business valuations are generally considered the act or process of valuing the business enterprise or an ownership interest in the business entity. The engagement of a qualified appraiser is necessary because of the appraiser's specific knowledge of the valuation methods and his or her experience in ascertaining value. When selecting a valuation professional, education, training and experience should all be considered. The appraiser should be certified by one or more of the recognized professional organizations.

For purposes of determining value, fair market value is generally considered "the price at which the property would change hands between a willing buyer and a willing seller, where the former is not under any compulsion to buy and the latter is not under any compulsion to sell, with both parties having reasonable knowledge of the relevant facts."⁴

Valuation is usually based on the going concern concept, value and continued use, and considers income, market and asset based approaches.

A typical appraisal report will analyze the following:

1. "Review of the nature of the business and history of the Company.

2. Discussion with management concerning the Company's services, operations and economic potential.
3. Consideration of the U.S. economic outlook and the present and prospective industry situation.
4. Review and analysis of financial information concerning the Company.
5. Analysis of earnings, cash flow and dividend-paying capacity of the Company.
6. Discounted cash flow analysis of the Company's future operations.
7. Review and consideration of corporations in similar lines of business whose stock is traded on the open market."⁵

In addition to the forgoing, the appraisal should also consider equipment and real estate leases and depreciation schedules, owner's compensation, major competitors, information about the company's transactions with related parties, and information as to the geographic area and economy surrounding the business.

The income approach values the business based on some form of economic income stream. Under the income approach, there is the discount method and the capitalized method. The market approach values by reference to other transactions and uses the guideline public company method or the guideline merged and acquired company method. The asset based approach values on the basis of assets and liabilities involved and employs an adjusted net asset value method and where applicable, an excess earnings method.⁶

Even troubled companies may have value in the current market. Intangible value may lie hidden in assets or business attributes.⁷

REVIEWING THE BUSINESS OWNER'S ESTATE AND FINANCIAL PLANS

As part of the transition process, the owners often engage in a thorough review of their own financial planning and accompanying estate plan, considering that the most significant asset in their economic environment is being converted into cash or cash and notes receivable.⁸ Taking a look into the future is called for. The owner's financial goals, how much money he or she will need to attain them, how much he or she would need to save and how much should be invested, should all be examined in detail.

Aspects of the owner's financial plan which should be reviewed include current assets, anticipated income, life insurance analysis, long-term care analysis, inflation and on-going living expenses. For many, the most important economic question is how will my family be able to maintain its lifestyle on a long-term basis, based on the after-tax proceeds from my portion of the sale of the business.

MARKETING ENVIRONMENT

The entity should assemble a marketing and administrative team. Key members of the team would include the upper level executives of the entity, particularly the CEO and CFO, and outside accountants, attorneys and financial advisers all having solid experience in selling businesses.⁹

Here before the sales process really begins, there should be a review of the financial trends of the business and a comparison of the Company's results to industry leaders. The goal should be to build a residual revenue stream. Significant Company obligations and commitments, including, leases and contracts, should be studied to determine their effect on value.¹⁰

Financial statements should be prepared using generally accepted accounting principles. A review of proposed expenditures should take place to eliminate those that do not contribute to business value.¹¹

The investment banker or investment advisor should research the price paid for similar entities, identify opportunities for the transaction, advise the Company concerning those opportunities and participate on behalf of the Company in negotiations with respect to the potential transaction.¹² Among the typical services provided by a financial advisor are:

1. Identifying prospective purchasers and strategic and financial buyers.
2. Developing marketing materials.
3. Initiating contacts subject to the execution of confidentiality agreements.
4. Engaging in discussions with prospective purchasers to determine preliminary interest in the transaction.
5. Assisting management in developing presentations tailored to specific interested prospective buyers.
6. Overseeing the development of a data room to facilitate the due diligence process.
7. Advising Company management and participating in the negotiations with respect to the transaction, including assisting with a letter of intent and purchase agreement development.
8. Assisting the Company and its legal and other advisors in resolving issues which arise throughout the transaction process.

The financial advisor can prepare a confidential information memorandum including the following:

1. "Industry and economic conditions, including regional economic overview, industry outlook, competition within the industry and the Company's position within the industry.
2. Company history and recent company developments.
3. Key managers, their responsibilities, experience and education.
4. Key customers, including diversification of the customer base.
5. Products and services.
6. Environmental considerations.
7. Vendor and manufacturer information.
8. General financial information showing patterns, trends and financial information.
9. Plant and facility information, including whether it is owned or leased, expansion possibilities, conditions, proximity to highways."¹³

SPRUCING A BUSINESS FOR SALE

Once a tentative decision is made to prepare the business for sale, consideration should be given to sprucing up the business in various ways.

Steps which can be taken to maximize the value of a business include reducing expenditures, such as salaries and administrative costs, deferring expansion, enlarging gross revenue by increasing sales and prices, eliminating obsolete inventory, cleaning up accounts receivable, obtaining contracts from customers, diversifying the customer base, eliminating unprofitable parts of the business and firming up distributorship and dealer agreements.¹⁴ This ongoing process can take several years.

Developing a good management team which can operate a sold business calls for hiring managers or training existing personnel to take these positions. You should identify managers who could acquire the business and start to develop a succession plan. Confidentiality and noncompete agreements should be obtained from key employees. Managers should be given incentives to develop the business with bonuses or golden parachutes if there is a sale of the business. Consider deferring management bonuses for a term of years which would be forfeited if the manager leaves before the term is up.¹⁵

FINANCING ENVIRONMENT

While we discuss the seller's objective in obtaining what he or she deems fair value from any transaction involving the disposition of substantially all the assets or substantially all of the shares of the business, from a buyer's perspective, the business

value is the present value of the expected future cash flows; the cash flows the buyer intends to use to pay the purchase price. Where financing involves a third party lender providing cash for all or a portion of the purchase price in a lump sum, risk is shared by the buyer and the lender. Financing can involve a series of payments from the buyer to the seller usually represented by a secured promissory note. While the buyer has exposure here, as a practical matter, the seller is also subject to business risk since the buyer is less willing to pay if the cash flow is not adequate to service the indebtedness. The seller can receive payments based on the business performance over a period of time following the transfer. Here, the timing of the buyer's payments can depend on business profitability. Equity financing is taking place.¹⁶

When the business disposition transaction involves a stock sale, there is only one level of gain; all of which will normally be treated as long-term capital gain (except for non-compete and consulting agreements) taxed at the 15% rate. When an asset sale takes place, the sale triggers gain within the entity. Another gain occurs when the sales proceeds are distributed in liquidation of a C Corporation. Here, the gain could be taxed at the 35% corporate rate, (plus state taxes) with the after-tax proceeds distributed to the shareholders as liquidating distributions then being taxed at 15% to the extent the distributions exceed the shareholders' basis. The favorable 15% rate on long-term capital gain and dividends will expire at the end of 2008. Where the entity is a pass through entity, such as an S Corporation or partnership, there is usually only one level of tax at the shareholder or partner level.¹⁷

The buyer generally desires an asset purchase to avoid potential liabilities. The purchase of assets may not require the approval of minority shareholders. The buyer also wants to be able to get a stepped up basis for certain assets, allocating the purchase price to deductible assets, which include equipment (which can be rapidly depreciated), inventory (which can be recovered as sold) and accounts receivable, (which are tax free as collected.) The buyer generally desires as little as possible to be allocated to goodwill and other intangibles which must be amortized over fifteen years.¹⁸

With a stock sale, the buyer will often require representations and indemnifications against liabilities, and will want to leverage buy-out deductions by utilizing consulting agreements and covenants not to compete, rental payments for real estate and shareholder owned equipment, and perhaps contributions to an ESOP.

To the extent personal goodwill, covenants not to compete or consulting arrangements are present, the tax structure varies. Consulting arrangements and covenants not to compete are taxed as ordinary income. Personal goodwill can be taxed directly to the shareholder.

Where the buyer pays income tax on earnings used to repay the debt, if the owners of a flow through entity are taxed on operating income at a 40% rate, the entity must earn \$167 to support a \$100 principal payment. If C Corporation dividends are taxed at a 20% rate, a \$125 dividend will produce \$100 after tax. To distribute \$125 to its C Corporation shareholders, a C Corporation that is subject to tax at a 40% rate must earn more than \$208 to support a \$100 principal payment.¹⁹

For a flow through entity, \$100 is necessary to support \$100 of interest. When a C Corporation is taxed at a 40% rate, \$167 of earnings are needed to fund a \$100 dividend.²⁰

From a seller's view, if the seller has a 20% tax rate, it nets \$80 on every \$100 of capital gain. The seller pays ordinary income tax rates on any interest. \$100 of interest income nets \$60 after tax.²¹

As to stock acquisitions, the preferred structure is for the buyer to acquire the seller's stock from its shareholders in exchange for cash, notes, property and an assumption of debt.²²

Under Section 338 of the Code, a corporate purchaser of C or S Corporation stock in a taxable transaction may desire to make an election by which the seller is deemed to have sold its net assets to a newly organized corporation. Where a Section 338 election is made by the buyer the seller is treated as though it had sold all of its net assets to a new corporation for their fair market value and then liquidated. Such a transaction will generally result in the recognition of gain by the selling shareholders accompanied by a second level of gain being recognized by the seller on the deemed asset sale. It is unlikely that this double taxation to receive a step-up in basis will be efficient from a tax perspective unless the seller has tax attributes, such as net operating loss carryovers, that are otherwise going to go unused.²³

Where an asset acquisition takes place, the desired structure is for the buyer to purchase the assets (and perhaps assume certain liabilities) of the business directly from the seller. The seller, following such a transaction, will hold, reinvest or distribute its sales proceeds, and each of these alternatives will bear its own tax consequences.²⁴

Cash is a form of consideration which usually ends a seller's interest in the business. The cash can be on hand insofar as the buyer is concerned, or come from the seller itself. Cash can also be raised by financing. Here, either the buyer, seller, or both could finance the acquisition.²⁵

Where the transaction is structured as an asset acquisition, the consideration is paid to the seller rather than to its shareholders. The gain or loss recognized by an entity on the actual sale of its assets is the excess of the amount realized with respect to the sale (including any assumed liabilities) over the entity's basis in its assets. The seller may then proceed to liquidate, distributing its after-tax proceeds as well as any remaining property to its shareholders. If any of the consideration for a stock purchase is in effect furnished by the seller in exchange for its own shares, that part of the transaction will constitute a redemption. This may give rise to either dividend or capital gain treatment.²⁶

Where payments are received after the acquisition itself, the treatment of the seller is more complex. If the amounts are realized on more than one date, it is necessary to ascertain when the proceeds are realized and the amount of basis recovered with each payment. A taxpayer who sells privately held stock at a gain may

be entitled to report the gain on the installment method. Here no gain is recognized on receipt of the debt itself. Each time an actual payment is received with respect to the debt, the seller recognizes income in an amount equal to the payment multiplied by the gross profit ratio; the total gross profit to the total contract price.²⁷ Where a transaction provides for an earn-out, contingent payment sale treatment comes into play.²⁸

Some transactions can qualify as tax free reorganizations. Here, assuming the continuity of interest, business purpose and continuity of business enterprise tests can be met, certain reorganizations can occur without the recognition of income for tax purposes.²⁹ An "A" reorganization is a statutory merger or consolidation.³⁰ The "B" reorganization is a reorganization in which an amount of the seller's stock constituting control is acquired in exchange for voting stock of either the buyer or a corporation which controls the buyer.³¹ With a "C" reorganization, an acquisition of substantially all the seller's assets takes place in exchange for the buyer's voting stock.³²

UNWANTED ASSETS

A buyer will often be interested in purchasing less than all of the seller's operations. A taxable asset sale is the most flexible way to dispose of the undesired assets.³³ A second approach is to have the seller sell groups of its assets to various purchasers with each acquiring what it wants to purchase.³⁴

Sometimes, a ready and acceptable purchaser may be unavailable for some of the seller's assets. It may be necessary to sell those assets for which there are buyers and distribute the remaining assets, along with the after-tax sale proceeds, in complete liquidation.³⁵ The buyer sometimes can be called upon to assume the risk of holding or disposing of unwanted assets. The seller transfers all of its assets to the buyer. The buyer can then dispose of the undesired assets, either by resale or otherwise.³⁶

Redemptions can be useful where the sellers desire to permit others to purchase an equity stock interest in the Company, but the buyers lack the necessary funds or do not want all the assets.³⁷

If the seller has liquid assets which are not needed, the buyer may seek to finance a portion of the price by the seller making a distribution to its shareholders prior to the sale. Such a redemption can result in gain being recognized at the corporate level.³⁸

The tax results from this approach were once considered uncertain. If the redemption occurred first, and shareholders status was unchanged after the redemption, the redemption was equivalent to a dividend. The Service has not treated the redemption as a dividend when both the sale and redemption took place at the same time³⁹. The courts, however, have determined that for this so-called Zenz⁴⁰ rational to apply, the redemption and the sale must be part of a single plan. This is less important where today the 15% dividend and long-term capital gain rates are the same.⁴¹

SEPARATIONS

With separate entities, an owner may want to transfer capital among related business entities. This can be accomplished by loans or making distributions to the owners followed by a re-contribution of the distributed amounts to new entities. Business structure and outside lenders can impose restrictions on the movement of funds and assets among entities and their owners.⁴²

Developing separate companies may allow for the eventual sale of only a portion of the business. Separate entities may enable one group of assets to be separated from another for liability purposes, provide training grounds for two different management teams, enable the organizations to have separate compensation arrangements and assist the companies in specializing in different product lines to concentrate on different vendors.

Where the shareholders desire to sell only certain parts of a business or want to give their children businesses one separate from the other, it is sometimes possible for the owners to split up their corporation tax free under Section 355 so that each of the shareholders ends up with a separate company.⁴³

If a corporation distributes to a shareholder with respect to its stock, or in exchange for its stock, stock or securities of another corporation which it controls immediately before the distribution, and the Section 355 requirements are satisfied, no gain or loss is generally recognized by the shareholder upon receipt of the controlled corporation's stock. The distributing corporation also enjoys non-recognition treatment on the distribution of the stock.⁴⁴

These distributions which result in a corporate division may be structured as a spin-off, split-off or split-up.

The division is a spin-off if the distributing corporation distributes stock of the controlled corporation to the distributing corporation's shareholders without the shareholders surrendering their stock in the distributing corporation.⁴⁵

A split-off is a non-prorata distribution of stock or securities of the controlled corporation. Stock in the distributing corporation is exchanged.⁴⁶

In a split-up, the distributing corporation distributes stock of two or more controlled subsidiaries to some or all of its shareholders. The shareholders surrender their stock in the distributing corporation in exchange for the stock of the subsidiaries. The distributing corporation liquidates.⁴⁷

There are number of strict requirements that have to be satisfied to achieve non-recognition treatment. The transaction must not have been used principally as a device for the distribution of earnings and profits.⁴⁸ The purpose of the distribution must be germane to the business of the corporations.⁴⁹ There must be a continuity to the entire business enterprise and a continuity of interest in all or part of the business enterprise

on the part of those persons who were owners of the enterprise before the distribution or exchange.⁵⁰

Under Section 355(e), gain would be recognized on certain distributions, particularly if one or more persons acquired directly or indirectly stock representing a 50% or greater interest in the distributing corporation or any controlled corporation during the four year period beginning on the date which is two years before the date of distribution.

Partnership and limited liability company separations (whether assets-over divisions or assets-up divisions) can generally be accomplished on a tax free basis.⁵¹

S CORPORATION ISSUES

Asset sales can cause higher taxes when an S Corporation is involved. Some assets, such as inventory, are taxed at ordinary income rates which can result in gain taxed at the highest ordinary income tax rate.⁵²

A larger issue for an S Corporations is the potential applicability of the built-in gains tax.

Under Section 1374, a corporate level tax is imposed on any gain that arose prior to the conversion ("built-in gain") and that is recognized by an S Corporation through sale or distribution, within ten years after the date in which the S election takes effect.. The amount of the gain that must be recognized, however, will be limited to the aggregate built-in gain of the corporation at the time of its conversion to S Corporation status. Built-in gains will be taxed at the maximum corporate rate for the year in which the disposition takes place. Net recognized built-in gain with respect to any year in the recognition period is the lesser of the amount that would have been taxable income to the S Corporation if only built-in gains were recognized and built-in losses were taken into account for the Corporation's taxable income for the year or the corporate taxable income as if the corporation was not an S Corporation. The recognition period is the ten year period beginning with the first day of the first taxable year which the corporation was an S Corporation.

Section 1374 does not apply, however, to any corporation that was an S Corporation with respect to each of its taxable years.⁵³

GOODWILL, GOING CONCERN VALUE AND COVENANTS NOT TO COMPETE

Goodwill is thought of as the positive earning power of an enterprise and expectations that customers will continue to patronize it because of its advantageous location or other similar reasons, or because of its competitive advantages.⁵⁴

Going concern value can be the added value assets have as an integral part of an operating enterprise.⁵⁵

Today, an acquiring entity has the ability to amortize goodwill and going concern value over a period of fifteen years.⁵⁶

Covenants not to compete entered into in connection with the direct or indirect acquisition of an interest in a trade or business are also treated as an intangible amortizable over fifteen years.⁵⁷

In certain transactions, sellers have not been required to recognize gain on the sale of goodwill to the extent the goodwill was considered the property of their key employees. The personal goodwill was not considered a Company asset.⁵⁸

ALLOCATION OF CONSIDERATION

In an applicable asset acquisition, both the seller and the purchaser must allocate the consideration in accordance with the residual method of allocation.⁵⁹

Under the residual method, consideration is allocated among seven classes of assets based upon fair market value in descending order of priority, the classes being:⁶⁰

- Class I - Cash and general deposit accounts.
- Class II - Actively traded personal property and certificate of deposits.
- Class III - Assets that the taxpayer marks to market at least annually for Federal income tax purposes.
- Class IV – Stock in the trade of business of the taxpayer, normally inventory.
- Class V – All assets other than Classes I, II, III, IV, VI and VII.
- Class VI –Intangible assets other than goodwill and going concern value.
- Class VII– Goodwill, going concern value and any remaining consideration.

Covenants not to compete are considered assets transferred as part of a trade or business.⁶¹

Where the parties agree in writing as to the allocation, or as to the fair market values of any of the acquired assets, the agreement is binding, and the Internal Revenue Service is restricted in challenging the allocation of the values arrived at under the allocation agreement. It has to show mistake, undue influence, fraud, etc.⁶²

USING ESOPS

When only certain shareholders decide to dispose of their interest in the business or when management decides to acquire the interest of the selling shareholders,

ESOPs are sometimes used in the business disposition transaction. Even when all of the shareholders are selling their interests in the corporate entity, ESOPs are sometimes used in combination with the acquiring shareholders to complete the acquisition of the business. Sometime a second class of stock is created for the ESOP transaction.

ESOPs are stock bonus or stock bonus and money purchase plans designed to borrow money and engage in transactions with related parties to acquire employer stock under circumstances which would otherwise constitute an ERISA prohibited transaction.⁶³

ESOPs invest primarily in employer securities, providing participants with certain voting rights, and giving participants the right to require that ESOP benefits be distributed in the form of employer stock. The employer can be called upon to repurchase the distributed stock if it is not readily marketable. ESOPs must meet certain distribution and non-allocation requirements, and restrict allocations to certain participants.⁶⁴

In a typical ESOP leveraged transaction, the Company will borrow funds and loan them to the ESOP or the ESOP will borrow the funds to be used by the ESOP to acquire employer stock. The Company then makes tax deductible contributions to the ESOP. When the ESOP uses the employer contributions to pay off its debt, the securities held by the ESOP (which are used as loan collateral) are released and allocated to the accounts of the ESOP participants.⁶⁵

ESOP contributions are deductible up to 25% of covered compensation with increased limits being available for contributions made to pay off the ESOP loan. Certain dividends are deductible.⁶⁶

Unless a participant elects a later date, distributions must begin no later than one year after the year in which the participant terminates employment, reaches normal retirement age, becomes disabled or passes away or the fifth year following the year in which he or she otherwise separates from service. Distributions of securities acquired with the proceeds of an ESOP loan may be delayed until the loan is repaid.⁶⁷

Where the employer stock is not publicly traded, ESOP participants can require the employer to repurchase any distributed employer stock at fair market value. If the ESOP benefits are distributed in a lump-sum, the employer may elect to pay the purchase price upon the exercise of the put option over a period not to exceed five years with interest at a reasonable rate so long as adequate security is provided.⁶⁸

A shareholder may achieve non-recognition of gain from the sale of qualified securities held at least three years to an ESOP so long as the seller purchases qualified replacement property within the replacement period. After such a sale, the ESOP must hold at least 30% of the value of the employer's outstanding stock. Gain on a sale that qualifies under Section 1042 is recognized only to the extent that the amount realized on the sale exceeds the taxpayer's cost of qualified replacement property.⁶⁹

Qualified securities are employer securities that were not received by the taxpayer as a distribution from a qualified plan or as a transfer pursuant to an option or other right to acquire stock⁷⁰. Qualified replacement property, which must be acquired within three months before or twelve months after the sale, is any security issued by a domestic operating corporation, other than the corporation that issued the securities involved in the non-recognition transaction.⁷¹

Once the Section 1042 election to defer tax is made, it is irrevocable.⁷² If an election is not made in a timely manner, the taxpayer may not make an election on an amended return.⁷³ Qualified replacement properties must be described in "statements of purchase" which are to be filed with the seller's tax returns.

Dispositions of the qualified replacement property can result in gain recognition to the extent of the gain previously deferred by reason of the taxpayer's acquisition of the qualified replacement property.⁷⁴

Exceptions to the recognition of gain on the disposition of the qualified replacement property include dispositions by death, gift and subsequent sales of the qualified replacement property to an ESOP pursuant to another Section 1042 transaction.⁷⁵

It is possible for a seller who is charitably inclined to contribute the replacement property to a charitable remainder trust. Such a contribution will not result in gain recapture. A seller does not report gain when the charitable remainder trust sells the replacement property, and will receive annual trust distributions from the investment of the sales proceeds. The seller can retain an annuity or income stream for his life and thereafter for the life of other beneficiaries, such as his or her spouse. An income tax charitable deduction for the value of the charitable remainder interest is available. If there is no beneficiary of the charitable remainder trust other than the seller and his or her spouse when the seller passes away, then there should be no estate tax at the seller's death.⁷⁶

CONFLICTS

Conflicts of interest among shareholders must be considered. They should consent in writing to have the same representation, or be advised they have the right to independent counsel.⁷⁷

There would seem to be a conflict among shareholders where some of the consideration is in the form of a consulting or employment agreement, or personally recognized goodwill for some entity owners, but not others. A conflict would also seem to arise where some owners own real estate through a related or unrelated entity that is not owned by other entity owners, and the property is either rented or acquired as part of a business sale.⁷⁸

Where one or more owners take tax positions that would not be beneficial to others, and a position taken by one party is challenged by the Internal Revenue Service, transaction consideration may need to be altered to reflect the intended results.⁷⁹

TRANSFERABILITY RESTRICTIONS

In many closely held businesses, reasonable transfer restrictions can be imposed upon entity owners. Ownership interests may be classified into voting and nonvoting interests to facilitate inter vivos and testamentary planning.

Agreements can be used to call for a redemption by the business entity or purchase by fellow owners at previously agreed upon prices. A series of transferability restrictions and purchase options or agreements can come into play in connection with transfers of the business interests. For example, with "Drag Along Rights," a majority of the business owners agreeing to the sale of substantially all of the assets or shares of the business can cause the other shareholders to in effect be dragged along into the transaction. "Tag Along Rights" provide minority shareholders with the ability to call upon the majority to include them in a transaction involving a sale of substantially all of the Company shares at the same or similar prices being paid to the majority shareholders.

THIRD PARTY CONSENTS

As to internal aspects in connection with preparing a business for sale, an effort should be undertaken to examine and review the need for third party consents.

Long-term debt, short-term debt, lines of credit, guarantees or other indebtedness, and any major covenants which could effect the day to day operation of the business should be reviewed for the necessity of approval by a lender or another for the sale of substantially all of the Company assets or sale of a certain percentage of its outstanding shares.

All licenses and patents, including trade names, service marks, copyrights or applications, should be reviewed to see if any consents are required for assignment.

Leases should be checked to see if they are assignable without consent.

All material permits, licenses and approvals of any Federal, state or local governmental authority as to the Company's employees, business, products or facilities, relating to any Federal or local government authority such as OSHA, FPC and EPA, should be reviewed.

NONQUALIFIED DEFERRED COMPENSATION

As to nonqualified deferred compensation, all employment agreements and deferred compensation agreements should be examined to see what provisions are included for distribution and acceleration of benefits in connection with terminations of employment and distribution of benefits in connection with a change in control, whether by a sale of substantially all the assets or a sale of a substantial percentage of the outstanding Company shares.

Section 409A provides that all amounts deferred under non-qualified deferred compensation plans for all taxable years are currently includable in gross income to the extent not subject to a substantial risk of forfeiture and not previously included in gross income unless certain requirements are satisfied. If the Section 409A requirements are not satisfied, in addition to current income inclusion, interest at the underpayment rate plus one percentage point is imposed on the underpayments that would have occurred had the compensation been includable in income when first deferred, or if later, when not subject to a substantial risk of forfeiture. Moreover, the amount required to be included in income is subject to a 20% additional tax.⁸⁰

Distributions from a non-qualified deferred compensation plan may be allowed without the imposition of the Section 409A taxes, upon separation from service, a specified time or pursuant to a fixed schedule or a change in control of a corporation. Under most circumstances, acceleration of distributions is not permitted. However, a plan may terminate and distribute its benefits if the business or business assets are sold.⁸¹

Regulations define non-qualified deferred compensation plans very broadly. While short term deferrals are excluded, the regulations encompass such items as non-qualified stock options, stock appreciation rights, phantom stock plans, separation pay arrangements (severance plans), split dollar endorsement life insurance arrangements, non-elective arrangements, employment agreements, certain corporation and partnership earn-outs, and performance based compensation.⁸²

Non-qualified deferred compensation arrangements are required to comply both in form and operation with the Section 409A requirements, and plans are now required to contain certain provisions in order to comply with both the statute and the regulations.⁸³

In connection with any business transaction which results in an employee or independent contractor covered under a nonqualified deferred compensation plan being separated from service or a change in control of a corporation, the underlying plans themselves should be examined to make sure they comply with the qualified triggering event and provide for a fixed time and fixed schedule for distributions.

The Internal Revenue Code calls for an excise tax on "golden parachute arrangements." No deduction is allowed for excess parachute payments.⁸⁴ The tax applies to disqualified individuals who receive golden parachute payments; that is, individuals who performed personal services for the corporation and who are officers, shareholders or highly compensated employees. Excess parachute payments are equal to the amount by which a parachute payment exceeds the portion of the base amount allocated to the payment. Parachute payments are payments in the nature of compensation which are contingent on a change in control or effective control of the corporation, or the ownership of a substantial portion of its assets, where the aggregate present value of the payments in the nature of compensation equal or exceeds an amount equal to three times the base amount (the individual's annualized includable compensation for the base period.)⁸⁵

Amounts that are not treated as parachute payments are not taken into account in determining whether the threshold contained in the definition of parachute payments is exceeded. This includes payments from or under a qualified plan.⁸⁶

There is an exception to the applicability of the golden parachute provisions with respect to a corporation which was a small business corporation or as to any payment to a disqualified person with respect to a corporation if immediately before the change in control no stock in the corporation was readily tradable on an established securities market and certain the shareholder approval requirements are met. The shareholder approval requirements would be considered met if the payment was approved by a vote of the persons who owned, immediately before the change in control or disposition of a substantial portion of the assets, more than 75% of the voting power, and there was adequate disclosure to the shareholders of all the material facts concerning all payments with respect to the disqualified individuals. The vote must determine the right of the recipients to receive the payment.⁸⁷

SPLIT DOLLAR AND BUY SELL INSURANCE

Split dollar life insurance is an arrangement between an owner of a life insurance contract and a non-owner, where one party pays all or part of the premiums and the party paying the premiums is entitled to recover those premiums, with the repayment flowing from, or being secured by, the policy proceeds.⁸⁸

Certain arrangements entered into in connection with the performance of services can be treated as split-dollar life insurance, regardless of whether the arrangements otherwise satisfy the general definition of split-dollar. Here, the employer pays all or a portion of the premiums, and the death benefit is designated by the employee or other service provider, or the employee or other service provider has any interest in the policy cash value. The same concept extends to shareholders.⁸⁹

Split dollar is generally characterized as being one of two mutually exclusive regimes; the economic benefit regime or the loan regime. Under the economic benefit (or equity split dollar) regime, the owner is treated as providing economic benefits to the non-owner, and both parties must account for these benefits fully and consistently. In equity split dollar, the economic benefit provided to the non-owner is current life insurance protection. An employee's economic interest in a contract purchased under equity split dollar includes a portion of the cash surrender value. Under equity split dollar, equity is defined as the amount of cash value less the cumulative employer premium investment.⁹⁰

The amount of current life insurance protection provided to a non-owner equals the excess of the contract death benefit over the amount payable to the owner, reduced by the policy cash value taken into account as a benefit or paid for by the non-owner, for the current or any prior year.⁹¹

Under the loan regime, the non-owner of the insurance contract is treated as loaning premium payments to the owner. This regime applies where payment is made

by the non-owner and the payment is a loan or there is an expectancy that the payment will be repaid. Repayment is secured by the policy's death benefit, its cash surrender value or both.⁹²

Where the split dollar arrangement is entered into in connection with the performance of services, the employer or service recipient is treated as the owner of the life insurance contract. The only economic benefit provided (at all times) is current life insurance protection.⁹³

When a business is sold, typically the split dollar life insurance arrangement is ended. Here, the transfer of a life insurance contract underlying a split dollar life insurance arrangement occurs when the non-owner becomes the owner of the entire contract. A transfer does not occur just because the cash surrender value of the contract exceeds the premiums paid by the owner or the amount ultimately payable to the owner on termination of the arrangement. There is no transfer of a contract where the owner merely endorses a percentage of the cash surrender value of the contract to the non-owner.⁹⁴

At the time of a transfer, there must be taken into account for Federal income and employment tax purposes the excess of the fair market value of the life insurance contract transferred to the transferee over the sum of (i) the amount the transferee pays to the transferor to obtain the contract and (ii) the value of all economic benefits actually taken into account by the transferee along with any consideration paid for economic benefits plus life insurance protection.⁹⁵

Moreover, if a transfer is subject to Section 83, fair market value is determined disregarding any lapse restrictions, and in addition the timing of the transferee's inclusion is determined under the Section 83 rules with the transfer not giving rise to gross income until the transferee's rights to the contract are substantially vested.

Where a collateral assignment under the loan regime is used, no transfer for value takes place when the policy is rolled out to the insured, or the insured's trust or another third party. Since the creation of a collateral assignment is not a transfer for value, the release of the collateral assignment should not be one either.⁹⁶

As to life insurance involved in funding cross purchase buy-sell arrangements, attention should be paid to the transfer for value rules. Death proceeds under a life insurance policy can be received free of income tax.⁹⁷ However, the transfer for value rules state that if a policy, or an interest, is transferred in exchange for valuable consideration, the death benefit received by the beneficiary is income tax free only to the extent of the beneficiary's basis; the acquisition costs plus premiums paid by the transferee on the policy.⁹⁸ There are exceptions to the application of the transfer for value rule. The rule does not apply to transfers for valuable consideration to the insured, a partner of the insured, a partnership in which the insured is a partner, or a corporation in which the insured is a shareholder or officer.⁹⁹ There is no exception, however, for transfers between shareholders. Hence, a transfer for value occurs if personally owned policies are transferred by a shareholder to other shareholders in

connection with the termination of a cross purchase buy-sell arrangement.¹⁰⁰ Some cross purchase life insurance arrangements have existing partnerships owning the policies, thus eliminating the transfer for value risk. However, this is not always the case.

CAFETERIA, FLEXIBLE BENEFIT AND WELFARE PLANS

Cafeteria plans, flexible benefit plans, tax-exempt fringe benefits, dependent care plans, educational expense reimbursement plans, sick pay, including short and long term disability, and other welfare plans such as medical coverage should be considered. Outstanding claims under any one or more of these plans should be examined to determine liability and related exposure.

If the medical plans are self insured, both the stop loss and aggregate insurance components should be studied to make sure the premiums are current and to note the coverage and terms of the policies involved.

Group health plans, including medical benefit plans, whether self-insured, or insured are normally required to comply with COBRA. Under COBRA, continuation coverage is extended when a qualifying event takes place which includes the death of a covered employee, termination (other than by reason of gross misconduct) or reduction of hours of the covered employee's employment.¹⁰¹

Allocations of the liability for COBRA coverage upon the sale of a business has been a thorny issue. The regulations provide the following principles:

- "A sale of stock is not a qualifying event.
- The seller of a business and all members of its control group are considered a single employer. A buyer of a business and all members of its control group are considered a single employer.
- If the selling group maintains any group medical plan after the sale, the selling group retains COBRA obligations for individuals whose qualifying events occurred before or at the time of divestiture.
- If the selling group ceased to maintain any group health plan in connection with the divestiture, COBRA obligations pass to the buying group.
- However, if the buying group in an asset sale does not continue the vested business without substantial change, COBRA obligations remain with the selling group."¹⁰²

The COBRA regulations, however, are not intended to limit the parties from contractually assuming COBRA obligations. Hence, many asset sales would be considered stock sales for COBRA.

QUALIFIED PROFIT SHARING, PENSION MULTI EMPLOYER PLANS AND ESOPS

As to qualified plans of deferred compensation, including multiemployer plans, profit sharing plans, pensions and ESOPs, the most recent determination letters should be reviewed as well as the last two Forms 5500. Claims experience for all plans should be studied, and the summary plan descriptions for existing plans should be examined. Details of outstanding litigation or threatened litigation should be examined, and the most recent attorney's response to the auditors request for information should also be studied. As to defined benefit plans and multiemployer plans, a statement setting forth the accrued and projected liabilities under each plan and a statement of the projected annual cost of maintaining each plan should be prepared.

Under the Internal Revenue Service procedures governing staggered remedial amendment periods, cyclical amendment periods are in place and every individually designed qualified plan has a regular five year remedial amendment cycle. At least once every five years the plan, as amended to comply with the most recent applicable statutory and regulatory requirements, must be submitted to the Internal Revenue Service for review.¹⁰³ Each Company plan should be reviewed to determine which cycle the Company is in and each plan should be reviewed in light of the applicable cycle remedial amendment period requirements.

As to any plans which are anticipated to be terminated as a result of a sale of substantially all of the assets of the business or the outstanding shares, Section 411 requires that upon partial termination as well as complete termination the rights of all effected participants and benefits accrued to the date of termination must be nonforfeitable to the extent funded.¹⁰⁴

Defined benefit plans should be examined from a funding perspective to ascertain to what extent the plans are funded on both an ongoing and plan termination basis.

ERISA contains a series rules that apply when an employer withdraws from a multiemployer plan. Generally, when an employer totally or partially withdraws from a multiemployer pension plan it may be required to continue funding a proportional share of the plans unfunded vested benefits by making annual withdrawal liability payments to the plan.¹⁰⁵ A complete withdrawal can occur when an employer permanently ceases to have an obligation to contribute under the plan or permanently ceases all covered operations under the plan.¹⁰⁶

While continuing withdrawal liability is generally imposed on an employer for transfers of corporate assets, a complete or partial withdrawal does not occur just because covered operations of the seller have been transferred to another employer¹⁰⁷ For an employer to escape withdrawal liability in connection with a transfer of corporate assets, the following conditions must be satisfied:

1. The buyer, an unrelated party, must be required to contribute to the plan for substantially the same number of contribution based units which the seller was required to contribute.¹⁰⁸
2. The buyer must provide the plan, for a period of five years starting with the first plan year beginning after the sale of assets, a bond or escrow in an amount equal to the greater of:
 - a. The average annual premium contribution made by the seller for the three plan years preceding the year in which the sale occurs, or
 - b. The annual contribution the seller was required to make to the plan for the last plan year before the plan year in which the sale occurs.¹⁰⁹
3. The seller must post a bond or escrow in the event that it distributes all or substantially all of its assets during the five years following the sale.¹¹⁰
4. The contract must provide that if the buyer withdraws in a complete or partial withdrawal during the first five plan years, and fails to pay the liability due, that the seller is secondarily liable for the withdrawal liability it would have had, but for the asset sale, if the purchaser's liability is unpaid.¹¹¹

If the seller maintains an ESOP, the plan meets the requirements of Section 409(e)(3) only if each participant or beneficiary in the plan is entitled to direct the plan trustees as to the manner in which voting rights under non-registration type employer stock which are allocated to the participant's or beneficiary's account are to be exercised with respect to any corporate matter calling for the approval or disapproval of any merger, consolidation, recapitalization, liquidation, dissolution or a sale of substantially all the corporate assets. An ESOP as a stock bonus plan or a combination stock bonus and money purchase pension plan, must comply with the Section 401(a)(22) qualified plan pass through voting requirements if more than 10% of its assets are employer securities.¹¹²

Under the Treasury Regulations governing ESOPs, an exempt loan must be without recourse against the ESOP and the only assets of the ESOP that may be given as collateral for an exempt loan are qualified employer securities acquired with the proceeds of the loan and those used as collateral for a prior exempt loan.¹¹³ No person entitled to payment under an exempt loan shall have any right to ESOP assets other than the collateral, contributions and earnings attributable to the collateral or the investment of such contributions.¹¹⁴

Several Private Letter Rulings have been issued that allow an ESOP to repay a loan with the sale proceeds of suspense account shares.¹¹⁵ A transaction may not be

designed with the intention of repaying a loan by the periodic sale of suspense account stock.¹¹⁶

The Regulations also provide that ESOPs may be amended to substitute a cash distribution for a required distribution in some other form of property (including employer securities) after termination. The employer must not maintain any other plan providing for distribution in the other specified property.¹¹⁷ Thus, it would seem that the requirements under which a participant entitled to a plan distribution has a right to demand that his or her benefits be distributed in employer stock (and where the employer stock is not tradable, have a right to require the employer to repurchase the stock under a fair market valuation formula) may not be applicable after an ESOP termination.

GRATS

The basic idea of a GRAT is simple – an individual ("grantor") creates a trust for a fixed period of time (usually for a term of years) and reserves to himself or herself a valuable interest during the term in the form of an annuity payment. The annuity is a percentage of the value of the assets transferred to the GRAT. Upon the expiration of the term, the trust property passes to the children or other family members.¹¹⁸ The transfer of the property to the trust itself is structured as a completed gift so that if the grantor survives the fixed term, the property passes to the remaindermen with no further gift tax cost.¹¹⁹

Discounted assets, such as closely held stock, are attractive GRAT candidates because the gift tax value and the annuity amount are based on the discounted value. An ideal asset to leverage a gift to a GRAT is an interest in a closely held business where substantial growth is expected over a relatively short time.¹²⁰

To avoid generating a taxable gift when the GRAT is created, zeroed out GRATs are often used. A zeroed out GRAT requires that the annual annuity payments to the grantor be set at a sufficiently high rate so that the present value of the retained interest, based upon the Section 7520 rate (120% of the Applicable Mid-Term Rate) will be roughly equivalent to the value of the contributed property. As a result, little or no Federal gift tax is required to be paid by the grantor when the property is transferred to the GRAT. Assuming that the grantor outlives the GRAT term, the GRAT property will then pass on to the next level of beneficiaries without further exposure to either gift or estate tax.¹²¹

The potential tax savings to be achieved by the GRAT depends in substantial part upon the Section 7520 rate in effect when the GRAT is created in conjunction with the rate of return which the GRAT is able to achieve on the GRAT property over its term. If the GRAT is able to achieve a return in excess of the Section 7520 rate, significant results can be achieved. On the other hand, if the GRAT is unable to achieve an adequate return, the GRAT benefits may be reduced or eliminated. Most of the GRAT property will be exhausted by the grantor's annuity payments.¹²² These in turn will be part of the grantor's estate for estate tax purposes. Where GRAT asset

values decline, the grantor can buy the asset at the lower value and create a new GRAT. Should the grantor die before his or her life expectancy, or conversely outlive his or her life expectancy, the benefits to be achieved will be affected.¹²³

The GRAT annuity payment may increase yearly by 120% of the percentage payable in the prior year. With smaller annual payments called for in the early years, a greater portion of the GRAT properties produce a larger return for the remaindermen.¹²⁴

Designing the GRAT as a grantor trust for income tax purposes results in the GRAT income being taxable to the grantor. The Internal Revenue Service has ruled that the grantor's payment of the income tax on the attributed income does not constitute an additional gift to the GRAT. Moreover, a GRAT can provide for discretionary payments to assist the grantor in meeting his or her income tax liability arising from GRAT transactions.¹²⁵

Disproportionate values result where the value of the property that can be distributed in satisfaction of the GRAT annuity varies from the value of the property used to fund the GRAT. Differences occur where the gifted GRAT asset is discounted due to lack of marketability or minority interest attributes. These may not be present when the GRAT assets are used at fair market value to fund the annuity. For example, the grantor may fund a GRAT with a control block of stock that is valued at a premium. However, when a smaller quantity of the shares is distributed in satisfaction of the required annuity, the distributed stock may be valued without any premium. Fewer shares would be used proportionately. The reverse may also occur. A block of stock contributed to a GRAT may carry a lack of marketability discount. However, when a portion is distributed in partial or complete satisfaction of the annuity payments, the distributed shares may be valued with a minority discount. Under such circumstances, more shares will have to be distributed to satisfy the annuity.¹²⁶

There may be advantages to short term GRATs. With a set of short-term GRATs, poor investment performance of one will not affect another short term GRAT with a return in excess of the Section 7520 rate. In a GRAT series, poor performance will not affect other GRATs. Moreover, with the use of short term GRATs there is less risk of the grantor passing away during the GRAT term, with the GRAT being included in the grantor's estate tax base.¹²⁷

Short term GRATs can result in adverse consequences. The Section 7520 rate may increase. Future GRATs rules may be adversely affected by new rules while preexisting GRATs are grandfathered. There are additional costs with a series of short term GRATs.¹²⁸

The Proposed Regulations on calculating the amount of estate tax owed if a GRAT grantor dies during the GRAT term can produce a larger estate tax value when the GRAT term is shorter.¹²⁹

INSTALLMENT SALES, SCINS & INTENTIONALLY DEFECTIVE GRANTOR TRUSTS

Installment sales involve a transaction with a seller agreeing to sell property in exchange for the buyer's promise to make periodic installment payments until a set sales price is received.¹³⁰

One significant difference between a traditional installment sale and a SCIN is that with a SCIN nothing is included in the seller's gross estate when the seller passes away before having received the maximum purchase provided for under the SCIN agreement. Since there is a limit on the maximum amount the buyer will pay and there is a chance that the buyer may actually pay less than the maximum stated price, the amount of the periodic payments under the SCIN must be greater than the payments under a traditional installment sale ("the risk premium"). Differences between SCINs and installment sales in the amount of the periodic payments will also lead to timing differences in terms of how quickly the seller will have to report the gain under the installment method.¹³¹

In recent years, tax planning opportunities have been presented by combining an installment sale or a SCIN with a so-called "Intentional Defective Grantor Trust" or "IDIT", that is trusts which are deemed to be controlled by the grantor for income tax purposes, but which are not includable in the grantor's estate for estate tax purposes. Here, no capital gain will arise from the grantor's sale to the IDIT. With a fair market value sale, there should be no gift, estate or GST tax. However, there is no step-up in basis. Usually, the IDIT would involve an irrevocable trust established by the grantor for the benefit of his children or other beneficiaries. The grantor does not retain any interest which would result in the estate taxability of the trust at his death.¹³²

By the grantor retaining certain powers set forth in Sections 671 through 677, the trust will be disregarded for income tax purposes. The grantor will be treated as having received directly any income tax attributes which would otherwise have been recognized by the trust.¹³³

Assume a grantor transfers closely held business interests to an IDIT in exchange for a trust installment note in an amount equal to the fair market value of the transferred interests. Typically, the IDIT has been prefunded with a taxable gift in order to provide the IDIT with an additional source of funds with which to meet its obligations under the installment note, and the property sold in exchange for the installment note serves as security for the IDIT debt. The note may provide for interest payments only, at least annually, for a specific period (perhaps fifteen years) with a single balloon payment at the end. Providing that the note bears interest at the Applicable Federal Rate, there should be no gift tax consequence resulting from this aspect. The note has a value equal to its face. A sale in exchange for a note should not constitute a gift where the note equals the value of the property sold. A gift could take place where the amount of the note is less than the value of the stock which was sold.¹³⁴

For income tax purposes, although this transaction normally constitutes a sale in the traditional sense, no capital gain would be recognized under the grantor trust rules. Moreover, the grantor would not be taxed separately on the trust interest payments when they are received.¹³⁵

Upon the grantor's death, the appreciated IDIT property should not be included in the grantor's estate. The grantor should not be deemed to be the owner of the property for estate tax purposes.¹³⁶ Only the amounts remaining due under the promissory note should be subject to tax in the grantor's estate,¹³⁷ and if a SCIN was used, no amount should be subject to tax in the grantor's estate.

As a result of this arrangement, the value of the IDIT property (that is, the discounted interests in a closely held business) regardless of how much in value the property may have appreciated subsequent to its sale, should pass to the IDIT beneficiaries free of any further transfer tax liability. By exchanging the promissory note for the IDIT property, the grantor has avoided capital gain upon the transfer and effected a "freeze" for estate tax purposes in the value of the property sold to the IDIT. Accelerated note payments could help the grantor fund his or her income tax obligations if the IDIT property is sold at a significant gain.

An installment or SCIN sale of property to an IDIT is not entirely without risk. Although the grantor may not recognize gain on the sale of the property to the IDIT, the IDIT property itself will retain its original income tax basis, denying the grantor's estate the benefit of a step-up in basis.¹³⁸ An issue exists, however, as to whether any deferred gain must be recognized if the IDIT holds a promissory note at the grantor's death.¹³⁹

COMPARISONS BETWEEN GRATS AND INSTALLMENT SALES

The installment sale can produce a better result where the total return exceeds the Section 7520 rate¹⁴⁰. The installment sale interest is lower than with a GRAT (The lower Federal mid-term rate is used.) and there may be more leverage with an installment sale.¹⁴¹ With a sale, if property values are increased on audit, a taxable gift may have taken place. An installment sale is superior in connection with capturing overperformance and reducing the impact of poor performance.¹⁴² A 105 day GRAT delay does not necessarily result in an advantage.¹⁴³ GRATs can self adjust values where annuity changes are based on the transferred assets later finally determined values.¹⁴⁴ A GRAT's success can depend on the grantor's outliving the GRAT term.¹⁴⁵

DIRECT GIFT

Where the expected yield may be high, an immediate taxable gift could be best. Any gift tax may be a small percentage of the gift, particularly on a present value basis. With both a GRAT and installment sale a portion of the value of the property will end up (through the GRAT payments or the note payments under the installment sale) in the grantor's transfer tax base. The GRAT and the installment sale can each give rise to

their own issues that may not be present with a gift. However, the asset involved may not increase as expected.¹⁴⁶

DISPOSITIONS WITH CHARITABLE REMAINDER TRUSTS

Sometimes a closely held business owner may be called upon to sell his or her interest when the stock involved has little basis.

For a charitably minded business owner, this type of situation could be suited for a Charitable Remainder Trust or CRT. An individual owner can transfer all or part of his business interest to a CRT, naming one or more charities as remainder beneficiaries and retaining an income interest for himself or herself and for his or her family that best serves their needs. Since the CRT is exempt from income tax, the trustee can sell the contributed assets without incurring capital gain taxes (the unrelated business income tax applies) and reinvest the proceeds.¹⁴⁷ More principal is available to generate future income.

A transferor may obtain an income tax deduction based upon the actuarial value of the remainder interest to charity in the year the contribution is made, resulting in current income tax savings. If a transferor desires to "replace" the assets which will be left to charity, the transferor can purchase life insurance in a separate "wealth replacement trust" in an amount equivalent to the anticipated amount passing to the charity at the end of the CRT term. The wealth replacement trust itself should be structured so that the insurance proceeds will not be subject to estate tax at the insured's death. Premium payments for the insurance policy can be funded, at least in part, by the tax savings achieved by the income tax charitable deduction plus any deduction carried over to future years. The current 15% capital gain tax rate makes this approach less attractive.

The CRT can be structured either as a "CRAT", with a noncharitable beneficiary receiving equal payments based upon the initial trust value, or a "CRUT," where the noncharitable beneficiary receives a fluctuating payment each year, based upon a percentage of the trust value at the beginning of each year.¹⁴⁸ The CRT can be established for a term of years, up to 20 years, or for the life or lives of one or more beneficiaries.¹⁴⁹ The minimum annuity or unitrust percentage is 5%, and can be higher. However, the payout rate cannot be more than 50%, and the value of the charitable remainder must be at least 10%.¹⁵⁰

Often times the charitable remainder is a private foundation with members of the grantor's family serving as trustees or directors. They are able to manage the charitable funds after the CRT beneficiaries pass on for the benefit of the publicly supported charities they select.

There are several CRUT varieties. Under a net income unitrust, "NICRUT", the income beneficiary receives the lesser of a stated percentage or the actual trust income.¹⁵¹ Under the net income with make up format, "NIMCRUT", the income beneficiary is entitled to the lesser of a stated percentage or the actual trust income.

Where the trust income for a year is less than the stated percentage, the trustee pays the beneficiary the actual income. The difference between the distributed income and the stated percentage can be made up in later years should the trust income exceed the stated percentage.¹⁵²

There is another type of CRUT, the "FLIP CRUT." This is a trust that is either a NICRUT or NIMCRUT. However, as of the first day of the year following the occurrence of a triggering event, it converts to a standard CRUT.¹⁵³

The CRT is irrevocable. The trustee must not be restricted from investing in assets which could result in the annual realization of a reasonable amount of income.¹⁵⁴ The trust must not be a grantor trust.¹⁵⁵ CRTs are subject to the private foundation restrictions on prohibited self-dealing and taxable expenditures and excess business holdings as well as jeopardy investments if a charity is one of the annuity or unitrust beneficiaries.¹⁵⁶

PREARRANGED SALE

If a CRT grantor enters into an understanding to sell his or her appreciated interest before turning it over to the CRT, the Internal Revenue Service could claim that the CRT's sale was a sale by the grantor. The grantor would have to pay the tax on the gain.¹⁵⁷

The Tax Court in Ferguson applied the assignment of income concept with the Appellate Court concluding that the right to the proceeds had ripened before the donation of a target's stock to a CRT. A merger resulting from a tender offer was practically assured before the transfer.¹⁵⁸

In these situations, it is important that the shareholder donor relinquishes dominion of his or her stock to the CRT before an event takes place that "locks in" the income realization. The gifted property should be relinquished to the CRT, and any actions associated with property ownership should be undertaken by the CRT trustee.

CHARITABLE STOCK BAILOUT

The redemption exception to the self-dealing excise tax provides an opportunity for a C Corporation to effectively use a CRT where the children are shareholders in a business which possess significant investment assets.

The parent shareholders could transfer part or all their shares to a CRT. After assuring the absence of any prearranged sale, the Company would redeem the gifted shares. Since a promissory note would constitute a prohibited act of self-dealing, cash would need to be used. The Company redemption would increase the children's corporate interests.¹⁵⁹ If a separate class of stock is created and used to fund the CRT, the corporation can be limited as to the stock redeemed.

PRIVATE FOUNDATIONS

Private foundations are charitable trusts or not-for-profit corporations created to hold assets for charitable purposes, usually for distribution to publicly supported charitable organizations. Contributions to private foundations can result in charitable income (subject to certain limitations) gift and estate tax deductions.¹⁶⁰

When an individual creates and contributes to a private foundation while living, that person is able to make a charitable donation while continuing to control the distribution of the Foundation's income and corpus, normally in favor of publicly supported charitable organizations.¹⁶¹ When the Foundation sells its donated assets, no capital gain tax is incurred. The Foundation is tax exempt. However, a 2% excise tax may apply to the gain in the year of sale.¹⁶²

An individual's income tax deduction for contributing to a private foundation is limited to the donor's adjusted basis except for qualified appreciated stock. There are limitations on the amount of deductible contributions that can be made to a private foundation. Cash contributions are deductible up to 30% of the donor's adjusted gross income. Contributions of appreciated long-term capital gain property give rise to deductions that are limited to 20% of adjusted gross income. A five-year carry forward is available.¹⁶³

A person may create a private foundation as part of his or her estate plan, to receive property upon the individual's death. The individual's estate would be entitled to an estate tax charitable deduction for any property passing to the foundation and the estate tax deduction is based upon the fair market value of the contributed property, without any percentage limits.

A private foundation offers the donor's family, as trustees or directors, an opportunity to work together toward the common goal of establishing an entity which may have a lasting impact on the community where the family lives or on a concentrated charitable activity. Older generation family members can assist younger family members in developing management and investment skills. The younger generation is afforded an opportunity to foster family goals after older family members move on.¹⁶⁴

Private foundations are subject to a series of excise taxes. When one of the excise tax rules is violated, modest taxes are first imposed with the penalties increasing where the prohibited act is not corrected.¹⁶⁵ Two excise taxes relevant to charitable planning with business interests are the prohibition against self-dealing and the prohibition against excess business holdings.

Under Section 4941, most financial transactions between a private foundation and disqualified persons are prohibited whether or not the transaction benefits the foundation. Among prohibited self-dealing is the sale, exchange or leasing of property, and any extension of credit, between a private foundation and a disqualified person.¹⁶⁶ Disqualified persons include substantial donors, foundation managers, and persons

holding more than a 20% interest in corporations, partnerships or trusts that are substantial donors.¹⁶⁷

There is an exception to the self-dealing tax for any transaction between a private foundation and a disqualified corporation pursuant to any liquidation, merger, redemption, recapitalization or other corporate adjustment, where all securities of the same class held by the private foundation are subject to the same terms. The terms must provide for the foundation's receipt of no less than fair market value.¹⁶⁸

An excise tax on a private foundation's excess business holdings is imposed by Section 4943. Excess business holdings arise when a foundation's holdings together with those of disqualified persons exceed 20% of the voting stock of a corporation. With non-corporate enterprises, profits interest is used rather than voting stock. Permitted aggregate business holdings can increase from 20 to 35% where effective control of the enterprise is in one or more persons who are not disqualified persons.¹⁶⁹

Where a foundation has excess business holdings, it must dispose of them in order to avoid the excess business holdings tax. The foundation has five years to dispose of excess business holdings acquired by gift or bequest. An extension can be requested.¹⁷⁰ Where the excess business holdings are the result of a purchase by a disqualified person, the foundation has ninety days to dispose of the excess holdings.¹⁷¹

Section 4944 imposes an excise tax on investments that jeopardize the carrying out of a foundation's exempt purposes. The Section 4944 tax applies to foundation investments, not to contributed assets.¹⁷²

CONCLUSION

Preparing to sell your business is the start of a process that will hopefully yield a rewarding financial remuneration on the disposition of what for most persons is their most significant asset. Preparation is a broad undertaking, and activities such as environmental inspections, developing a marketing target, preparing for due diligence and entering into an auction phase lie ahead. Beyond these steps, the process will hopefully result in a letter of intent, a contract and a successful closing. Much remains to be done.

¹ John W. Hayes, *Business Valuation Considerations, How to Value a Company for the Sale or Purchase of a Business*, Illinois CPA Society Business Owners Exit Conference, May 23, 2007, 2.

² Myron E. Sildon, *A Practical Guide To Selling The Family Business*, ALL-ABA Course of Study Estate Planning for the Family Business Owner, August, 2002, 658.

³ *Id.*

⁴ Rev. Rul. 59-60, 1959-1 C.B. 237.

⁵ Hayes, *supra*, note 1, Example Report, 1.

⁶ Hayes, *supra*, note 1, at 7.

⁷ Patrick F. McNallay, *Valuating a Family Business: Even Troubled Companies May Be Worth More in Today's Market*, *The Journal of Corporate Renewal*, September, 2006, 1.

- ⁸ Mark J. Gilbert, *Perspectives of the Prime Advisors Financial Goal Plan*, Illinois CPA Society Business Owners Exit Conference, May 23, 2007.
- ⁹ Eric Lunstrom, James A. Korreck, Lou Kenter, Zane Cohn, *The Marketing and Selling of a Business*, Illinois CPA Society Business Owners Exit Conference, May 23, 2007, 0.
- ¹⁰ *Id.* at 1.
- ¹¹ *Id.* at 2.
- ¹² Sildon, *supra* note 2, at 657.
- ¹³ *Id.* at 659.
- ¹⁴ *Id.* at 654.
- ¹⁵ *Id.* at 655.
- ¹⁶ Steven B. Gorin, *Transfer of Family Business Interests: Finding the Sweet Spot Between General Income Tax, Chapter 14 and Code §409A*, American Bar Association Tax Section Winter Meeting, January, 2007, 1.
- ¹⁷ Nora Stapleton, *Tax Considerations Upon Selling a Business*, Illinois CPA Society Business Owners Exit Conference, May 23, 2007, 1.
- ¹⁸ Phillips and Rothman, 770-3rd T.M., *Structuring Corporate Acquisitions – Tax Aspects*. A- 57.
- ¹⁹ Gorin, *supra* note 16, at 2.
- ²⁰ *Id.*
- ²¹ *Id.*
- ²² Phillips and Rothman, *supra* note 18, at A-7.
- ²³ Section 338 of The Internal Revenue Code of 1986, as amended (the "Code") and Phillips and Rothman, *supra* note 18, at A-13.
- ²⁴ Phillips and Rothman, *supra* note 18, at A-18.
- ²⁵ *Id.* at A-21.
- ²⁶ *Id.* at A-29.
- ²⁷ Temp. Regs. §15A. 453-1(b)(2)
- ²⁸ Temp. Regs. §15A. 453-1(c)(1)
- ²⁹ Phillips and Rothman, *supra* note 18, at A-67 through A-71.
- ³⁰ Section 368(a)(1)(A).
- ³¹ Section 368(a)(1)(B).
- ³² Section 368(a)(1)(C).
- ³³ *Id.* at A-153.
- ³⁴ *Id.*
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- ³⁷ Doloboff, Koutouras, Gross and Matragano, 767-2nd T.M., *Redemptions*. A-125.
- ³⁸ *Id.*
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- ⁴² Mark D. Anderson, *Protecting Business Assets*, Illinois Institute for Continuing Legal Education, Asset Protection Planning (2007), 8-17.
- ⁴³ See Michael V. Bourland, *Family Business Succession Planning for the Dysfunctional Family: Special Tools and Considerations; Tax-Free Division*, 2006 Annual Notre Dame Tax and Estate Planning Institute, at 31-3.
- ⁴⁴ Section 355.
- ⁴⁵ Bourland, *supra* note 43, at 31-4.
- ⁴⁶ *Id.*
- ⁴⁷ *Id.*
- ⁴⁸ See Section 355(a) and (b).
- ⁴⁹ Treas. Regs. §1.355-2(b).
- ⁵⁰ Treas. Regs. §1.355-2(c).
- ⁵¹ Bourland, *supra* note 43, at 31-38 through 31-40.
- ⁵² Stapleton, *supra* note 17, at 1.

- ⁵³ Section 1374. See generally, Starr and Sobol, 731-2nd T.M., *S Corporations: Operations*. A-19 and A-33 through A-36.
- ⁵⁴ Rothman, Brady, Capps and Herzog, 561-2d T.M., *Capital Assets*. A-59.
- ⁵⁵ Treas Regs. §1.1060-1(b)(2)(ii).
- ⁵⁶ Section 197(a).
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- ⁵⁸ See *Muskat v. U.S.* (U.S.D.C. Dist. N.H.) 2007-2 USTC §89,259(2007).
- ⁵⁹ Section 1060(a).
- ⁶⁰ Treas. Regs. §1.338-(6)(b).
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- ⁶³ Kaplan, Morrison, Brown, and Granados, 354-7th T.M. *ESOPs*. A-1.
- ⁶⁴ See Section 409(a),(b),(e) and (h).
- ⁶⁵ Treas. Regs. §54.4975-11(c) and (d).
- ⁶⁶ Sections 404(a)(9) and (k).
- ⁶⁷ Section 409(o)(1)(B).
- ⁶⁸ Section 409(h)(5).
- ⁶⁹ Section 1042(a) and (b).
- ⁷⁰ Section 1042(c)(1).
- ⁷¹ See Section 1042(c)(3) and (4).
- ⁷² Treas. Regs. §1.1042-IT Q & A (3) and David Ackerman, *ESOPs As A Succession Planning Strategy*, Chicago Bar Association Federal Taxation Committee Presentation, November 2, 2006, 8.
- ⁷³ *Id.*
- ⁷⁴ Section 1042(e).
- ⁷⁵ Kaplan, *supra* note 63, at A-22.
- ⁷⁶ *Id.* at A-23. See, Private Letter Ruling 9234023.
- ⁷⁷ Sildon, *supra* note 2, at 671.
- ⁷⁸ *Id.* at 672.
- ⁷⁹ *Id.*
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- ⁸² Treas. Regs. §1.409A-1(a)(1), (b)(4) and (c).
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- ⁸⁴ See Sections 280G and 4999.
- ⁸⁵ Section 280G(b)(2)(A). Wilson and McGowan, 396 T.M., *Golden Parachutes*, A-2 and A-3
- ⁸⁶ Section 280G(b)(6).
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- ⁸⁸ Treas. Regs. §1.61-22(b). These rules apply to arrangements entered into after September 17, 2003. For a summary of the prior rules, See Brody, Richey and Baier, 828 T.M., *Compensating Employees With Insurance*. A-57 through 61.
- ⁸⁹ See Treas. Regs. §1.61.22(b)(2)(ii) and (iii).
- ⁹⁰ Preamble to Split-Dollar Life Insurance Arrangements, T.D. 9092, 2003-46 I.R.B. 1055, 1056, and 1058.
- ⁹¹ Treas. Regs. §1.61-22(d)(3)(i).
- ⁹² Treas. Regs. §1.7872-15(a)(2).
- ⁹³ Treas. Regs. §1.61.22 (c)(1)(ii)(A).
- ⁹⁴ Treas. Regs. §1.61.22 (c)(3).
- ⁹⁵ Treas. Regs. §1.61-22(g)(1) and Brody, *supra* note 88, at A-65.
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- ⁹⁷ Section 101(a)(1).
- ⁹⁸ Section 101(a)(2). Brody, Richey, Thater and Baier, 386-3rd T.M. *Insurance Related Compensation*. A-18(2).
- ⁹⁹ Sections 101(a)(2)(A) and (B).
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- ¹⁰¹ Section 4980B(f)(3)(A) and (B).

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- ¹⁰⁴ Section 411(d)(3).
- ¹⁰⁵ Section 4201 of The Employee Retirement Income Security Act of 1974 ("ERISA").
- ¹⁰⁶ Section 4203 of ERISA.
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- ¹¹⁸ See Roy M. Adams and Ann B. Burns, *Ordinary and Extraordinary Estate Planning – Effective Strategies for Small, Medium and Large Estates*, Cannon Financial Institute, Inc., August 14, 2007, 5.
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- ¹²⁰ *Id.*
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- ¹²⁴ Adams, *supra* note 118, at 6.
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- ¹²⁷ *Id.* at A-57.
- ¹²⁸ *Id.*
- ¹²⁹ See. Prop. Regs. 20.2036-1(c) REG 119097-05, 6/7/2007.
- ¹³⁰ Blattmachr, *supra* note 122, at A-86.
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- ¹³² See Michael D. Mulligan, *Sale to a Defective Grantor Trust: An Alternative to a GRAT*, 23 Estate Planning No. 1 (1996) 3.
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- ¹⁴⁰ Blattmachr, *supra* note 122, at A-97.
- ¹⁴¹ *Id.*
- ¹⁴² *Id.* at 98.
- ¹⁴³ *Id.*
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- ¹⁴⁵ Blattmachr, *supra* note 122, at A-93.
- ¹⁴⁶ Blattmachr, *supra* note 122, at A-96.
- ¹⁴⁷ Section 664(c).
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¹⁵⁶ Section 4947(a) and (b)(3) and Treas. Regs. §53.4947-2(b).
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¹⁵⁸ *Ferguson v. Comm'r*, 174 F.3d 997 (9th Cir. 1999).
¹⁵⁹ Daniels, *supra* note 157, at 14-64.
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¹⁶³ Daniels, *supra* note 157, at 14-4.
¹⁶⁴ *Id.* at 14-5.
¹⁶⁵ *Id.* at 14-37.
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