Pre-liquidity planning starts early—very early

It's natural for business owners and executives to put significant time and energy into the sale of a business. However, the financial planning considerations of a merger, acquisition, initial public offering or recapitalization are usually a distant secondary concern.

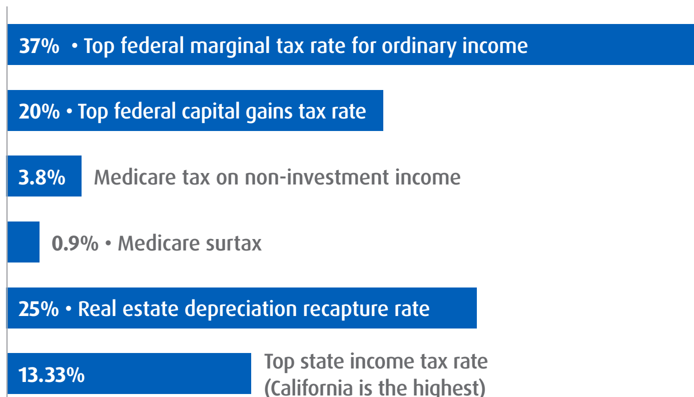
But liquidity events like these can be an incredible opportunity to build generational wealth; and, early planning is crucial to help maximize the proceeds from the transition and minimize wealth-eroding taxes.

Working with an experienced team can help you identify and navigate these issues in order to optimize your goals and objectives—*as long as you start early*.

A taxing proposition

Naturally, whatever liquidity event you undertake you will incur costs. You may not realize, however, that taxes will most likely be your largest transaction cost. A liquidity event opens you up to a whole laundry list of taxes.

Below is a rundown of each and the top rate you are likely to pay.



Impending sale: What's the ownership structure?

The ability to plan for taxes depends on the business's ownership structure.

Sale to strategic buyer

The tax consequences will differ based on whether the business is operated as a C-corporation or an S-corporation.

If the legal entity is a regular C-corporation, a stock sale (as opposed to selling the assets), is more desirable. The proceeds are generally taxed at favorable capital gains rates. Moreover, for qualified small business stock the stock sale can yield a significant deduction. An asset sale, on the other hand, carries two levels of tax: one at the corporate level for the assets sold and one at the shareholder level for the distribution of the net proceeds to the business owner shareholder.

Conversely, if the business is structured as a pass-through, a limited liability company or partnership, there will be only one level of tax at the time of the asset sale. However, if you reside in a high-tax state like California, which has the highest state tax rate, the asset sale would produce a much higher tax bill.

Understanding the tax consequences of the transaction will not only allow for a more informed decision but if a buyer is insisting on a more punitive sale structure, this knowledge can serve as leverage for negotiating a higher sale price.

Real estate used by business
It's not unusual for business real estate to be owned by the business owner individually or in a separate entity and leased back to the company. At the time of sale, pay attention to the real estate. Should you sell the real estate to the buyer or retain ownership and continue leasing it to the purchaser after the sale?

Naturally, those two paths have pluses and minuses.

If you decide to sell the real estate and the asset is held individually, then there will only be one level of taxation. On the other hand, if the real estate is owned by a traditional C-corporation then you could be looking at two levels of taxation.

Moreover, for a sale, if you've taken depreciation over time, a portion will need to be recaptured. Recapture is taxed at 25% with any gain in excess of the depreciation recapture taxed at the regular (lower) capital gains tax rate. Conversely, lease payments could be treated as passive income. When added to your other investment income, they could trigger the 3.8% Medicare surtax.

Deal structures can drive tax burden

Pay attention to how a deal is structured because it could result in higher taxes. For example, an all cash offer, while it might reduce risk, could be costlier from a tax perspective. Installment payments, on the other hand, could minimize taxes, but they carry risk. For example, the possibility that the buyer won't run the business as profitably as you and may default on the note.

In an all-cash deal, the initial upfront payment is treated as the sale of a capital asset and subject to the more favorable capital gains tax rate of 20%. When there are payments beyond the first one, utilizing the installment sale method typically makes the most sense. But special rules apply. You must spread out your tax basis to later years, when those subsequent payments are made. That increases your taxes upfront. And you run the risk of wasting your basis in later years if those payments are not received. There might be instances when it makes sense to opt out of installment payments.

Again, knowing all the tax ramifications of deal structure can guide you in your negotiations. You may consider negotiating a higher sale price to compensate you for the higher taxes that will result from an all-cash deal.

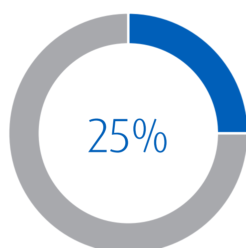
Initial Public Offering (IPO) on the horizon

For some entrepreneurs, a public offering is an important goal for their startup. Some IPOs are arranged in a matter of months; others can take up to a year to plan out. Again, the more time you give yourself, the more likely it is that you will be able to obtain the best long-term financial result.

It is not uncommon for companies to grant stock options to founders and employees. The taxation of stock options depends on whether the stock options are non-qualified stock options (NQSO) or incentive stock options (ISO).

NQSOs
These are not taxed at the time the option is granted if the exercise price is set to fair market value on the date of the grant, but will be taxed as ordinary income at the time the option is exercised. The amount taxed is the spread between the value of the stock at the time of exercise and the value of the stock at the time of the grant. If the stock received as a result of the exercise of the option is then held for a year before it is sold, the appreciation between the time of exercise and the time of sale is taxed as long-term capital gain.

ISOs
These are not taxed at the time of the grant or even at the time of the exercise. If the stock received as a result of the exercise of the grant is held for two years after the grant of the option and one year after the exercise of the option, the gain on the sale of the stock will be long-term capital gain (lower tax rate) rather than ordinary income. Note, however, that although there is no regular income tax on the exercise of an ISO, the spread between the grant value and the exercise value is a preference item for Alternative Minimum Tax (AMT) purposes, which can sometimes result in the payment of AMT in the year the ISO is exercised.



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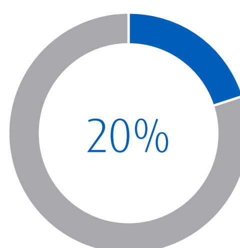

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Recapitalization for family business

Owners of family businesses often prefer to keep the business in the family, but they wish to unlock some of the owner's investment or they want to transfer ownership to the next generation. One method to accomplish this is through a leveraged recapitalization, allowing them to obtain some liquidity, retain significant ownership (and potential upside) and continue operating the company if they desire.

A leveraged recapitalization allows owners to borrow or issue debt and use the proceeds to buy back shares or distribute equity dividends to shareholders. Today's low interest rates may make debt an attractive alternative to selling.

Estate tax considerations

Your liquidity event will also have implications on your estate planning. Again, advanced planning can make a difference on how much money you are able to pass to your heirs.

The current estate tax exemption is $11.7 million per person and $23.4 million per married couple (at least until 2025, when it will revert to the previous $5.6 million amount). After the exemption amount, upwards of 40% could be exposed to federal estate taxes.

Consider for example, a married couple with a $40 million estate. The first $23.4 million can pass free of estate tax. The next $16.6 million is subject to federal estate tax.

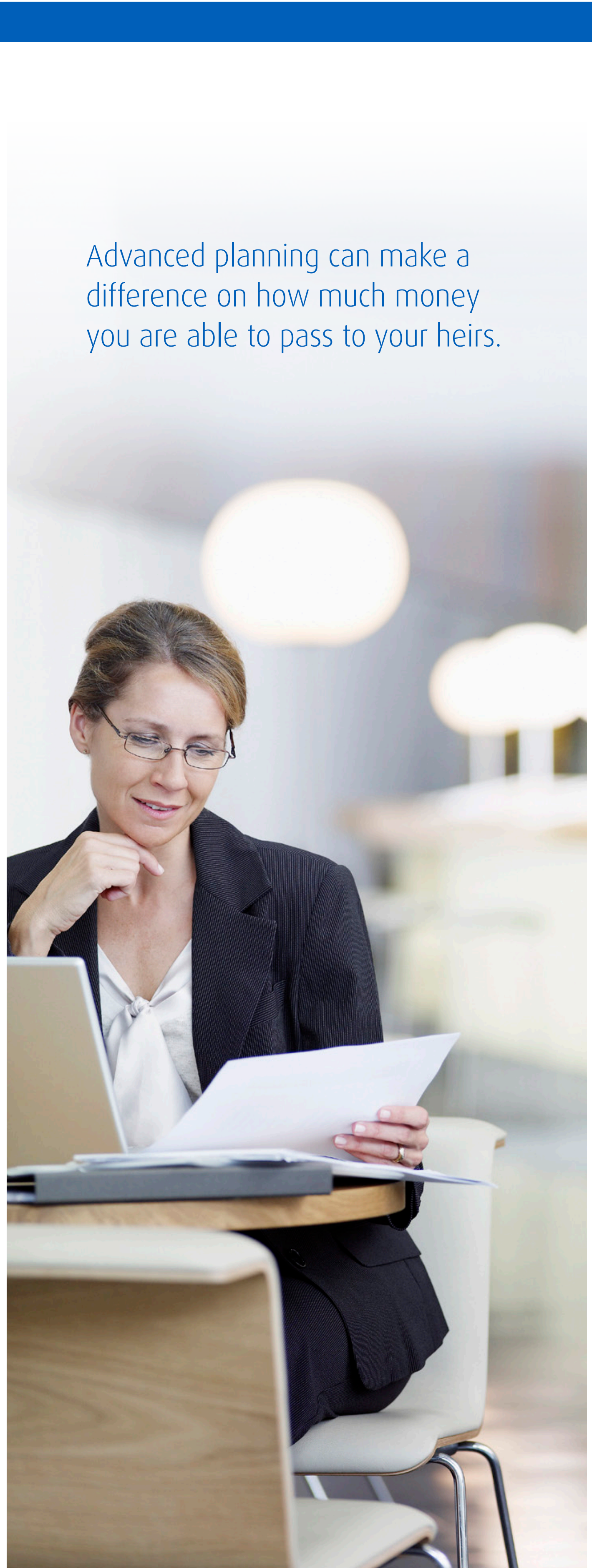
But over time, due to prudent investing, the amount of an estate exposed to the federal estate tax could grow significantly. Even a modest hypothetical 3% return compounded over 30 years, would increase a $40 million estate to $97 million—leaving an incredible $80.4 million subject to estate taxes under today's regulations.

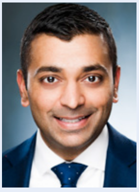
There are a number of strategies to deal with in this estate planning challenge:

Trusts
Transferring portions to a Grantor Retained Annuity Trust (GRAT), Intentionally Defective Grantor Trust (IDGT) or Charitable Remainder Trust (CRT) allows the growth to take place outside the estate and therefore sheltered from estate tax.

Gifting
Leveraged gifting of assets to future generations can significantly reduce your overall estate tax burden.

Life insurance
Insurance can be used to create liquidity at time of death in order to fund the estate tax obligation.





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Pratik oversees the delivery of integrated wealth management advice and client service for ultra-affluent clients. His expertise includes financial planning, tax planning, wealth transfer planning, charitable and philanthropic planning, family governance and education planning and business owner and corporate executive planning.

Plan early, plan often

The best planning leaves plenty of time to consider all your options prior to a liquidity event. There are many choices to consider, whether you are selling your company, taking it public or recapitalizing it to transfer to the next generation.

Understanding all the tax ramifications of each option will guide you during the transaction so you can structure a deal that's in your best interest and that of your family. It will help you decide to sell or hold, the price, deal structure and timing.

Be sure to have the right team in place that can advise you pre- and post-liquidity to help you minimize taxes and maximize wealth.

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