Tax Deferment Strategies

By Ron Buck

There are several strategies that can be used to defer the taxes due related to the sale of a business. Below is an outline of several of the most well-known. Most of these approaches can be used in conjunction with others. As tax matters are very specific to an individual company and its shareholders/members, *sellers are encouraged to seek specific advice from a CPA or tax attorney familiar with these approaches to determine the suitability for their situation.* Nothing herein shall be consider or construed as tax or legal advice.

Asset Allocation

Early in the process, an estimate of the value of the inventory (lower of cost or market) to be transferred, the market value of Furniture, Fixtures, and Equipment (FF&E), the amount to be assigned to a non-compete, and any personal goodwill (for a c-corp) will be determined. These items are generally negotiated due to the natural contention between Buyer and Seller that the IRS has set up (i.e., each party wants the amount to go in the opposite direction, therein exists a natural check and balance for the IRS). These allocations will impact the amount of taxes assigned to ordinary income and capital gains tranches.

Seller Finance

A common feature of transactions below $10 million is that the Seller provides financing for the transaction of 10-15% (sometimes up to 25% or more, depending on the transaction and company specifics). The seller finance portion has a built-in tax deferment component in that the taxes on the principal and interest are not due until the payments are received, per the amortization schedule, unless the loan is repaid early, in which case the tax is due in the period received. Seller finance may also move tax payments to a period when the Seller is in a lower tax bracket.

1031 Like-Kind-Exchange

A more complicated tax deferment strategy is known as a 1031 Like-Kind-Exchange. In this approach the Seller sells their current real property and reinvests, or “exchanges”, the proceeds into another similar, or “like” property even if they differ in grade or quality. It is known as “1031” for the section of the IRS code that authorizes it and is used for real estate.

To qualify, the properties exchanged must be held for productive use or for investment. Real properties are generally considered of like kind, regardless of whether the properties are improved or unimproved. Real property can be exchanged into income producing property, vacation rental, and land. Generally, "like kind" in terms of real estate, means any property that is classified real estate in any of the 50 U.S. states, and in some cases, the U.S. Virgin Islands.

To elect the 1031 recognition, a taxpayer must identify the existing property for exchange before closing, identify the replacement property within 45 days after closing, and acquire the replacement property within 180 days of closing. A “Qualified Intermediary” must also be used to facilitate the transaction, by holding all the profits from the sale, and then disbursing those monies at the closing of the replacement property, or sometimes for fees associated with acquiring the new property. More than one potential replacement property can be identified as long as you satisfy specific rules. This approach requires engaging a specialist.

Deferred Sales Trust {also see table below}

A Deferred Sales Trust (DST) defers the Seller's desired portion of the gain of a sale of business or property (from a small portion to all of it, except for the Depreciation Recapture Tax portion, see below) for typical period of up to 10 years, and can be renewed for another 10 years. DSTs are governed by Internal Revenue Code Section 453 and have been successfully utilized for over 20 years. In this structure, the proceeds are paid by the Buyer at Closing, but the deferred portion is placed in a separate trust, a "deferred sales trust". The trust invests the cash proceeds in securities portfolios with similar investment objectives and risk tolerances to the seller, very similar to a portfolio which might be done for a seller inside of an IRA or retirement account.

The Seller becomes a noteholder (creditor) to the trust, and the trust makes the agreed upon payments to the noteholder, pursuant to a payment agreement called an "installment sales contract". Under this contract, the trust is obligated to make installment payments to the noteholder (seller), representing interest on the pre-tax proceeds or principal from the sale, or both. If the noteholder (seller) has other income and doesn't need the payments right away, they may elect to defer the start date of the note payments. The repayment terms and schedule can be flexibly structured (at inception) in a variety of ways to best serve the needs of each specific taxpayer. This includes the continuum from minimal repayment of principal or rapid amortization. In addition, the commencement of payments can be immediate or can be delayed into the future.

Over time, as the Seller receives the funds from the trust according to the predetermined schedule, the taxes are due when the proceeds are received. This transaction type is particularly helpful for a seller who desires a diversified investment account. Trusts are especially appropriate in circumstances where a seller desires an independent long-term manager and trustee, wishes family financial matters to be private, does not have family members whom he/she would trust with financial decision-making powers, has charities desired to be benefited, or wants to protect significant family assets from creditors or future liabilities through control by the trust and trustee. This approach requires engaging a specialist.

One thing to note for the DST, <u>it only applies to the capital gains portion of the proceeds</u>. The Depreciation Recapture Tax (the amount owed on the gain on the sale of the physical assets based on(the difference between the amount allocated to furniture, fixtures, and vehicles versus the remaining net asset value for them on your taxes), is due the period that the transaction closes and cannot be deferred.

	Deferred Sales Trust (DST)
Tax Advantage	Defers taxes due until principal and interest is received. Allows Seller to earn investment income on the amount of taxes due until deferred tax payment is made. May also move tax payments to a period when the Seller is in a lower tax bracket.
Size	Typically >$1 million purchase price, with at least $100k of deferrable capital gains taxes.
Parties	Buyer – Seller – Trustee
Funds Flow / Flexibility	• Transaction proceeds go to Trustee at Closing • Seller receives proceeds as set up in payment schedule at beginning of trust (many flexible options, but must be determined at inception) • Taxes due as principal and interest received
Fund Investment	Invested by Trustee as Seller directs
Term	3, 5, or 10 years; can be renewed for additional 10 years
Tax Rate	Taxed at the then current tax rates (interest is taxed at your then current ordinary income tax rate, and principal received is taxed at your then current capital gains tax rate).
Fees	• Attorney set up (one-time) fees of 1-1.5% • Annual trustee fees of 0.5% • Annual financial advisor fees of 0.5% to 1.0% • Annual tax return $500 to $1,000

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Note: If considering a Monetized Installment Sale, the reader is encouraged to review CCA_2019103109421213, UILC: 453A.04-03, Number: 202118016, Release Date: 5/7/2021