Business Transition Considerations

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When I work with clients who are considering a sale of their business or practice, the path to a successful transition almost always includes significant considerations related to what you want the sale to do for you personally and for your future financial security. In many circumstances, while potential clients might have done personal financial planning along the way, integrating the business sale into their tax, financial, investment, family, work, and estate planning is a process which can easily take several years from start to finish. Done properly, the result at the end is usually extremely satisfying, but getting from point A to point B on a business or practice sale can be a long process, and may be more complex than envisioned when initially contemplated. My goal is to help you understand what to expect, and to work with you and your advisers to educate you about the process so you can then make educated decisions. All of your advisors will have specific areas which they advise and represent you, and my words of wisdom would be for you to employ advisers for this transaction who have experience in exactly what you are contemplating. My general rule of thumb is you will pay for experienced advisers and receive knowledgeable education and advice related to your specific circumstances, or you will pay for your current advisors to get educated. The goal of this discussion is to set your expectations as to what the transaction might be like.

Business or Practice Transitions

When considering a business or practice sale, my primary recommendation is to garner as much information and education about your potential transaction as possible. The bottom line is most owners have not gone through this process, and because in today's business, finance, and tax environment there are many interrelated items at a new or higher level. In many circumstances the seller is not certain what the proceeds will be from a sale, and whether those proceeds will be sufficient to fund lifestyle or retirement needs. Because of this, significant tax and financial planning for the individual may be needed with the business sale. Typically we would recommend future cash flow models for clients and some examples based upon varying situations (different sale prices, after-tax net, benefits of tax deferral, assumed investment returns, longevity, coordination with other investment and retirement assets/accounts with their respective cash flow streams). At the time of the sale, the seller's investment objectives and risk tolerances may change dramatically, as the business vehicle which funded many of those investment accounts will no longer be owned. In addition, since the business was typically the main driver of their income and many of their investments may have been more oriented towards growth, a reorientation of the investments to derive more income from the current investment accounts and future investment accounts which will be created from the business sale is very common. Many clients also have significant family desires they wish to fund or enable related to the sale. Lastly, taxes are a huge issue related to a sale and tax mitigation is generally foreign to most sellers and their advisors. Integration of the sellers CPA, attorney and financial advisor is critical for the process.

Deferring Taxes on Sales Via Tax Deferred Installment Sales

Tax deferred installment sales through unrelated entities are a newer sale process which most sellers and their advisors are not familiar with. In general they involve the option and sale of the business assets to an independent trust or LLC, and receiving from the entity an installment obligation as consideration. The entity resells the business to a buyer, and receives the cash proceeds from the sale. These proceeds are invested primarily in securities investment accounts at a national custodian (Schwab, Fidelity, TDA, Merrill). The installment note may be structured to pay out varying amounts depending upon need and accumulation desires, as well as taking into account family distribution or estate needs. With proper tax positioning of the entity it may be possible to accumulate accrued payments in a tax-deferred manner (similar in holdings and tax treatment to an IRA or 401k). Similar to investments which a seller might fund after a taxable sale, the proceeds are invested in a diversified securities portfolio and paid out in an established schedule. The accounts are invested by the trustee/manager in a manner which suits the investment objectives and risk tolerances of the seller, and the seller has a security interest in the specific accounts. This process will typically take coordination between the business seller, his advisors (primarily CPA and legal) and the entity tax attorney. These discussions are necessary for understanding, proper structure and tax accounting of the transaction. It is rare that I come across situations where the advisors have participated in a similar installment sale process prior to the contemplated transaction, so in many circumstances independent advisors with specific tax and legal experience have to be consulted.

Because of the ability to defer the taxes through the use of the installment sale, taxes will not be paid on the principal until it is received. A seller can then receive income payments for a predetermined period of time on the entire proceeds rather than the after-tax proceeds. This typically results in a 25%-50% increase in the portfolio balance and income which can be distributed from this account. While this may sound somewhat confusing, the seller has the option of structuring the installment note in a manner which suits the varying future income needs (similar to distributing from an IRA). As those needs may change over time, the installment obligation can also be customized to accumulate more in the early years and distribute more in the later years. My general rule of thumb is if an owner is considering selling a business would reinvest the after-tax proceeds in a securities account designed to generate growth or income, utilizing the entity installment sale will typically utilize the same investments for the same purposes, only with significantly more assets and potential distributions. Consideration to look at making a sale partially taxable to generate free cash at the time of the sale also occurs.

1031 Exchanges

IRS Section 1031 Like -Kind Real Estate Exchanges are extremely appropriate for the business owner who also has business occupied real estate. When you are contemplating the sale of a business that has real estate, this is probably the best tax break available. If you follow all of the IRS rules and regulations for complete tax deferral on a 1031 exchange, your gain as well as your current low tax basis on the asset will roll over into your replacement investment property. I generally view the sale of business real estate as appropriate at the time of sale of the business. Many of the business real property assets are relatively special use, would be extremely difficult to convert into some other type of investment property, and may have only one natural buyer (the buyer of your business). Because many business sellers are retiring, I would rarely recommend for their retirement real estate portfolio investing in a single use property with only one natural buyer. With a 1031 exchange you can convert their business investment property into a comparable alternate investment property at no tax cost.

My general recommendation for 1031 exchanges is to consider them as long as it is appropriate for you to own investment real estate in your investment portfolio after the sale of your business. This really comes down to looking at how diversified you are inside and outside of real estate and what percentage of your net worth this single property might be. In many circumstances we consider partial exchanges, where some money may be cashed out at a sale and some reinvested with a 1031 exchange. In numerous circumstances where it might be financially imprudent in retirement to have a large amount of money invested in a single property, we have also been able to facilitate multiple 1031 exchanges into portfolios of properties or ownership of properties with other investors, which although it may reduce your control will significantly aid in your diversification and concentration risk. The other very nice part about 1031 exchange planning is that potentially the tax can be avoided in its entirety, including the new 3.8% Medicare tax on investment income which is typically applicable to property sales. If it is appropriate to own investment real estate as part of your retirement portfolio, at the time a 1031 replacement property becomes part of an estate (upon the death of an owner), the heirs typically receive a step-up in basis to current value and all of the gain which originally had tax due at the time of the 1031 exchange is eliminated. This is potentially one of the best tax planning tools related to the 1031 exchange, and cause for timely work to be required associated with the consummation of a business sale (since 1031 exchanges have some extremely tight timelines to fulfill replacement property requirements). A custom 1031 plan can be easily integrated with retirement and estate plans assuming investment real estate is an appropriate retirement financial asset.