BUSINESS TRANSITION SERVICES, INC.

Business and Private Asset Sale Tax Deferral Options

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The sale of a business or private asset typically involves the sale of stock or entity interests, or fixed/tangible assets plus goodwill on an asset sale. On a stock sale, all of the tax can be potentially deferred via the use of an installment sale. On an asset sale, typically whatever is allocated to goodwill can be deferred through an installment sale. The question becomes how to defer the tax through an installment sale but not take on the business risk entailed when you finance the purchase to the buyer of your business. In particular with the current active business financing market for purchasers with excellent interest rates for borrowers, it makes little sense for a seller to owner finance (usually at a lower rate) and assume that business risk. What essentially occurs for a seller in a tax-deferred installment sale or assignment to a third party is a transfer of business risk in a smaller private asset to business risk in a larger credit rated company, or a transfer of business risk to investment risk in a government bond portfolio or securities portfolio (of appropriate desired risk) belonging to the obligated entity.

There are several installment methods which defer the taxes. Some use a sale via an installment note to an unrelated 3rd party, and others involve an assignment of the installment note to a 3rd party trust, LLC, or insurance company. In either circumstance, the third-party receives cash proceeds, with the seller receiving an installment note and a security interest in the 3rd party's assets (typically securities) or a guarantee from a third-party (insurance company, government bond portfolio, pooled asset account). All of these sales hinge on the third-party purchaser being an unrelated party (and there being some business substance to the transaction), or an assignment of the installment obligation to a third party in a format which follows prevailing installment sale law. Several also combine the creation of a third-party installment note with a credit line or loan to the seller which is paid by the installment obligation, giving the seller some liquidity at the time of sale. Following is a list and brief description of the author's knowledge of currently available methods.

1. Treasury Funded Installment Sale. In this transaction the installment obligation agreement between the asset seller and buyer allows for the transferring of the obligation (by way of a non-qualified assignment) to a third-party special-purpose company (newly formed irrevocable trust). This trust funds the installment obligation payments via the purchase of United States Treasuries held in the trust investment account, and the funded treasuries specifically mature and the payments from these maturities last the duration of the installment note (up to 30 years). The trust company requires a fee to assume the obligation and manages the investments for the duration of the note. Because the trust which funds the obligation contains US Treasuries, this note is effectively guaranteed by the full faith and credit of the US government, likely making it the most secure installment obligation. While quite secure, the current low interest rate on the treasuries leaves a little bit to be desired for some sellers. In this example the sale will be taxed over the duration of the payment stream.
2. Nonqualified Structured Settlement funded by an annuity. Several insurance companies have set up offshore entities to allow the non-qualified assignment of an installment note to their insurance subsidiary in return for a period-certain annuity lasting the duration of the note. The result is an installment obligation guaranteed by the

credit of an insurance company, which typically is a substantial credit enhancement above owner financing to a business or real estate buyer but a step below a treasury funded sale. The negative on this transactions is many of the insurance companies have curtailed these offshore activities and current fixed annuity rates are also quite low (with most funded by fixed income bond and treasury investments). In this example the sale will be taxed over the duration of the payment stream.

3. Nonqualified Structured Settlement funded by a pooled investment account. There are several companies which will now receive an assignment of an installment obligation and fund the obligation from a pooled investment account of a designated risk level and duration. While potentially significantly better from a return perspective than the annuity or treasury funded installment obligations, the pooled nature of it makes structuring it in an individualized manner a little more difficult and the rates of return variable depending upon what level of risk is in the pooled account. In this example the sale will be taxed over the duration of the payment stream (unless it is not a fully amortizing note, then the majority of the taxes will be due with a balloon payment at maturity). Risk is somewhat greater than the previous 2 examples but also dependent upon the specifics of the portfolio, and the interest rate on the loan may vary depending upon the risk profile of the account. Investment management is with large national securities firms approved by the structuring company, which also takes a transaction fee for constructing the sale. Any excess returns on the account above the level required to pay the installment note are the property of the pooled account provider. Repayment of the note is subject to the return on the pooled account. For sellers desiring some liquidity at the start of a transaction, lines of credit from other unrelated companies may also be obtained up to a certain percentage of the note amount with automatic crediting and debiting of the note payment utilized to fund the repayment of the credit line (with care taken to be in compliance with installment sale pledging rules).
4. Collateralized Installment Sale. In this version the asset seller sells to an intermediate company which then sells to an end buyer, with the intermediate company receiving the cash proceeds and the seller receiving a note. The seller then receives a credit line from an outside bank, and the payments from the installment note are automatically credited and debited to pay the loan (line (with care taken to be in compliance with installment sale pledging rules), and the seller receives about 95% of the proceeds of the transaction as credit line proceeds. Because the seller has received cash up front, he will not receive installment payments over the term of the loan as they will be utilized to pay back the loan. In this example the sale will be taxed over the duration of the payment stream used to pay back the note to the lender, unless the payment stream is interest only and then the entire principal and taxes will accrue at the balloon. The intermediate collateral company charges a fee for the transaction, and at the end of the process the collateral company retains a spread on the amount of the note which is repaid. Repayment of the note is subject to the return on the collateralized account. This transaction is typically for a seller who wants access to cash without a current tax bill.
5. Deferred Sales Trust (DST). In this version the asset is sold to an unrelated trust which then resells it to the end buyer, with the trust receiving the cash sale proceeds and the seller receiving a note from the trust. This note is quite flexible, as payments can be interest-only or fully/partially amortizing, and interest can either be paid or accrued (which could grow the balance due on the note). 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. Explicit note payment instructions are obligated for the trust to follow, payment of which depends upon the performance of the investment portfolio, and excess returns inside the portfolio above the required note payments are the property of the trustee. In this example the sale proceeds will be taxed over the duration of the payment stream (hopefully at a lower tax rate because it is not a lump sum payment), unless it is not a fully amortizing note and then there will be a balloon payment and associated taxes at the balloon. This transaction type is particularly helpful for a seller who desires a diversified investment account with greater return and greater interest rate on the note. Trusts are especially appropriate in circumstances where a seller might desires and independent long-term manager and trustee,

wishes family financial matters to be private, does not have family members whom he 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.

6. Family Self-Directed Installment Sale (SDIS). Multiple companies are crafting transactions in a manner which allows minority family ownership of a purchasing entity (LLC) initially, with family ownership and control increasing to 100% interest over time. Investment accounts utilized inside the purchasing entity reflect the investment objectives and risk tolerances of the seller (and family), and customization of distributions with integration into family and estate planning is available. In this example the sale proceeds will be taxed over the duration of the payment stream (hopefully at a lower tax rate because it is not a lump sum payment), unless it is not a fully amortizing note and then there will be a balloon payment and associated taxes at the balloon. This transaction type is particularly helpful for a seller who desires a diversified investment account with greater return and greater interest rate on the note. Repayment depends upon the performance of the investment portfolio, and excess returns inside the portfolio above the required note payments are the property of the family LLC. In this transaction, the returns from the investments inside the purchasing entity can be partially utilized to fund the installment obligation and partially utilized to fund desired family investment growth or distributions. The strategy may also be a little bit more personal, gift and estate tax beneficial in situations where parents are gifting to their children. LLC distributions to family members may end up being more tax friendly than gifting by a higher earning (and higher tax rate) parent, and the LLC may be utilized as a funding source for other family objectives. Income earned by the family LLC may be partially taxed as capital gains and dividends, whereas installment note interest payment income to the seller will be taxed at ordinary income rates with all other strategies. All investment income in this approach accrues to the seller or family members (versus outside trustees, managers, or companies), which may provide some desired flexibility in structuring the investments, distributions, and family planning.

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