BUSINESS TRANSFER PLANNING: A TALE OF TWO SELLERS

For many business owners considering a sale of their business, maximizing enterprise value becomes a singular focus and the proverbial finish line. Beyond the finish line, however, is the looming reality of the tax haircut this enhanced wealth may face when it passes to heirs. Additional issues around how the family will meet its objectives with the "new" balance sheet must also be considered.

LET'S START WITH TAXES

By transferring a portion of their business interest into structures that will avoid gift or estate tax, Sellers may retain a significantly greater percentage of this growth in their family's wealth.

THE THREE DELTAS

Delta One – Avoiding Tax on Valuation Discounts

Creating discounted interest can greatly enhance tax savings. Discounts are typically available for minority non-voting and non-marketable interests, which can generally be created through a fairly simple recapitalization process.

Rather than utilizing $10 million of gift and estate tax exemption to pass $10 million of non-discounted interest, it is far better to transfer that same interest at a value that is reduced by a 30% to 35% valuation discount. When the business interest is later sold, the discount evaporates and all shares receive the per-share sale price. In this scenario, nearly $14.3 million of post-sale non-discounted business interest has been transferred (assuming a 30% discount), while utilizing only $10 million of the owner's exemption. This is referred to "freezing the discount."

Delta Two – Avoiding Estate Tax on the Increase in Enterprise Value (EV)

Future appreciation, or the "pop" in value many business owners enjoy as a result of a successful sales process, may also be structured to occur outside of the taxable estate, further enhancing the retention of family wealth.

Delta Three – Avoiding Estate Tax on Appreciating Net-Worth Post-Sale

After the liquidity event, this newly monetized wealth can remain in tax advantaged vehicles that will continue to protect subsequent growth from estate taxation. Over the future years of wealth accumulation, the potential tax savings can be staggering.

FINANCIAL LIFE AFTER THE BUSINESS IS MONETIZED

How will the family meet its objectives with the new balance sheet? With the liquidation of what is typically the primary asset of a business owner's family, the necessity to manage objectives, income and risk becomes paramount. Many families are challenged to successfully navigate the change and sustain wealth across generations. To be prepared, careful financial modeling and testing is needed. The following basic elements of a plan should be considered well in advance of the sale of the business:

I. Define objectives with realistic values and growth expectations taken into consideration.

II. Determine the appropriate size of a safety net for the family.

III. Design a strategy to support and continue the family's lifestyle.

IV. Identify aspirational objectives and generational intentions.

TAX IMPACT ANALYSIS – A TALE OF TWO SELLERS

We assume two sellers in a highly fictional "exact" situation, but for the fact that Seller One (Sally) was referred by her Investment Banker to her wealth planning team for pre-transfer planning. Seller Two (Sam) was not. Both businesses were originally valued at $30 million (the "base" value). Each concluded a very successful sales process and sold their businesses in three years for $60 million. After taxes and costs of $10 million, the net proceeds from each sale was $50 million. However, both sellers are subject to federal estate tax. In other words, without any planning, when the owner transfers wealth to his or her heirs, the IRS becomes the welcome recipient of 40% of this appreciation in EV resulting from the successful sales process.

Sally's Planning Strategy

I. Three years prior to the sale, Sally implemented a strategy to remove a 25% minority, non-voting interest from her taxable estate, retaining full control of the business.[i]

II. Sally recapitalized her interest into voting and non-voting shares.

III. Sally then created a trust that is excluded from estate (but not income) taxation, known as an Intentionally Defective Grantor Trust, or "IDGT," referred to herein simply as her "Trust."

IV. Sally seed funded her Trust with a relatively small gift.

V. Sally then sold a 25% non-voting interest to her Trust, which qualified for a 30% discount and was valued at $5.25 million.

VI. Sally took back a 9-year, $5.25 million, interest-only balloon note, with a required mid-term AFR.

VII. The sale to Sally's Trust avoided capital gains due to its structure as a Grantor trust and the proper crafting of the terms of the sale.[ii]

VIII. Capital gains will, however, be recognized upon the sale of the interest to a third party, including on all shares held in Sally's Trust.

UNIQUE TIMES / UNIQUE SITUATIONS

As with all elements of planning, pre-transfer planning should be done in coordination with the business owner's comprehensive estate plan, particularly in this present time of uncertainty as to our future estate tax regime. When appropriate to meet the core goals and objectives of the business owner, pre-transfer planning can have a significant impact on the family's enduring wealth. Your Oxford team of advisors can assist in determining the proper strategy for each client's unique situation.

[i]Sally's advisors crunched the numbers and selected a recapitalization of Sally's interest into voting and non-voting shares. After properly capitalizing a trust that is excluded from estate taxation (known as an Intentionally Defective Grantor Trust, or "IDGT"), Sally sold a 25% discounted minority interest to the IDGT in return for a 9-year, $5.25 million interest-only balloon note (the amount of the originally discounted value of her interest), with a required mid-term AFR. This "sale" avoided triggering any capital gain due to the properly crafted structure of the sale and terms of the IDGT.

[ii]The sale to Sally's Trust is only successful when the appreciation in the underlying asset exceeds the AFR hurdle rate.

BUSINESS TRANSFER PLANNING: A TALE OF TWO SELLERS *(continued)*

THE THREE DELTAS	SALLY	SAM
DELTA ONE Tax savings attributable to discounts	As a result of the re-capitalization, the discount on Sally's 25% interest, valued at $2.25 million, has been frozen from her taxable estate. Without any further growth, this gesture alone would result in estate tax savings of $900,000. **Result: Potential estate tax savings of $900,000.***	Sam did no recapitalization or pre-transfer tax planning. **Result: Estate tax savings of $0.**
DELTA TWO Estate tax savings on the sale proceeds	Assuming sale proceeds of $60 million (and not considering income taxes), Sally's shares held in her Trust would now be worth $15 million (i.e., 25% of the full sale proceeds). Thus, Sally has removed an additional $7.5 million from her taxable estate (over and above the frozen discount of $2.25 million and the note back of $5.25 million). **Result: Additional estate tax savings of $3 million, wealth that will remain in the hands of Sally's family and not the IRS.***	With no planning, the full premium value of $30 million will be subject to the 40% estate tax. Sam's family will retain only $18 million of this enhanced enterprise value. **Result: Estate tax savings of $0.**
DELTA THREE Exponential impact on future legacy	The portion of the income tax attributable to the Trust shares was $2.5 million. While Sally is ultimately responsible for all income tax on the sale, she opted to be reimbursed by the Trust. Sally's Trust thereafter held $12.5 million of her new wealth. Assuming 30 years of additional growth with a 6% net return, this value will accumulate to $71.7 million. The estate tax on this wealth accumulation (under current law) would be $23.7 million. **Result: Potential additional legacy estate tax savings of $23.7 million.***	All of Sam's future accumulation in wealth will occur within his taxable estate. **Result: Estate tax savings of $0.**

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