


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## INCOME TAX EXIT STRATEGIES FROM BUSINESSES

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**STEVEN B. GORIN**  
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314-552-6151  
sgorin@thompsoncoburn.com  
<http://thompsoncoburn.com/people/steve-gorin>  
<http://www.thompsoncoburn.com/insights/blogs/business-succession-solutions>



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
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### Overview

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- Type of Entity
- Seller-Financed Sale of Portion Attributable to Goodwill
- Deferred Compensation

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
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### Overview

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- Basis Step-Up Issues
- Which Entity for Which Stage
- Life Insurance Issues
- Leveraging Real Estate

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
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### Type of Entity

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- Corporation
  - C Corporation
  - S Corporation
- Partnership
  - Limited Liability Company
  - Limited Partnership
- Limited Liability Company
  - Partnership or Disregarded Entity
  - S or C Corporation

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### Seller – Financed Sale of Goodwill

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Part II.Q., especially II.Q.1.a.i.

- C Corporation Triple Taxation and Double Taxation
- S Corporation Double Taxation
- Partnership Single Taxation
- Partnership Use of Same Earnings as S Corporation

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
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### C Corporation Triple Taxation

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```
graph TD; A["Business Operations ($238)"] --> B["Corporation ($143)"]; A --> C["Tax on Corporation ($238 x 40% = $95)"]; B --> D["Shareholder (Purchaser) ($100)"]; B --> E["Tax on Shareholder ($143 x 30% = $43)"]; D --> F["Seller ($70)"]; D --> G["Tax on Seller ($100 x 30% = $30)"];
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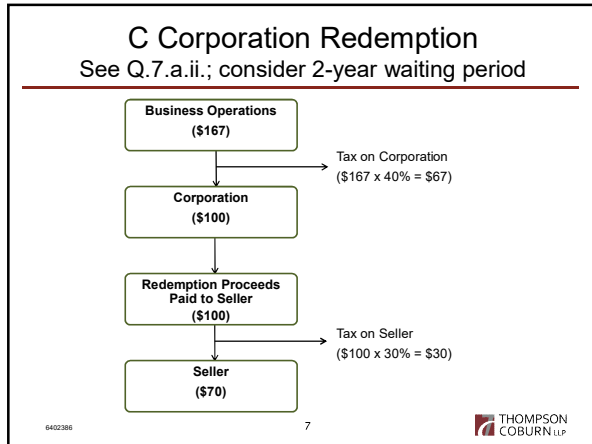
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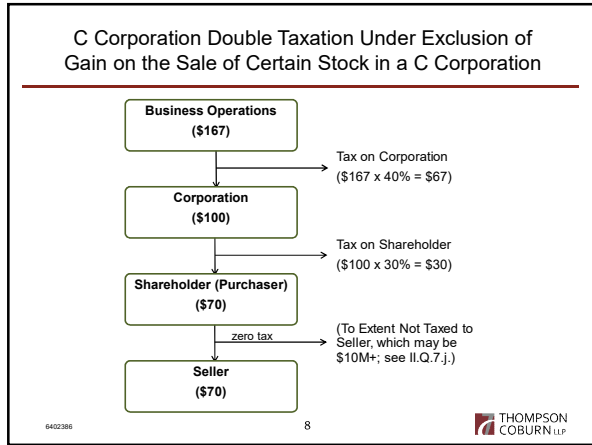
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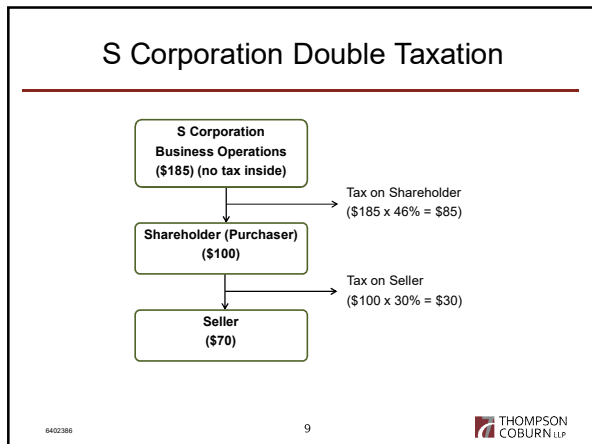
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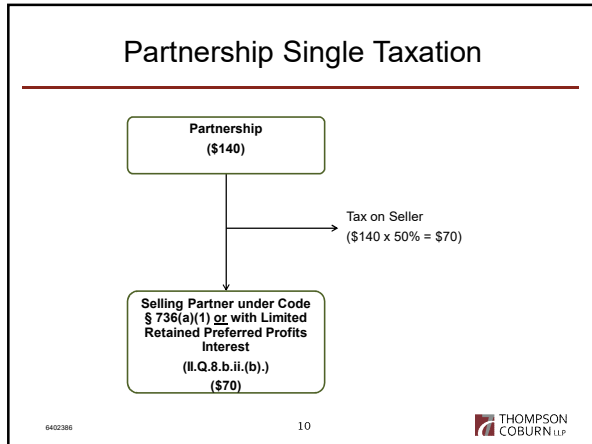
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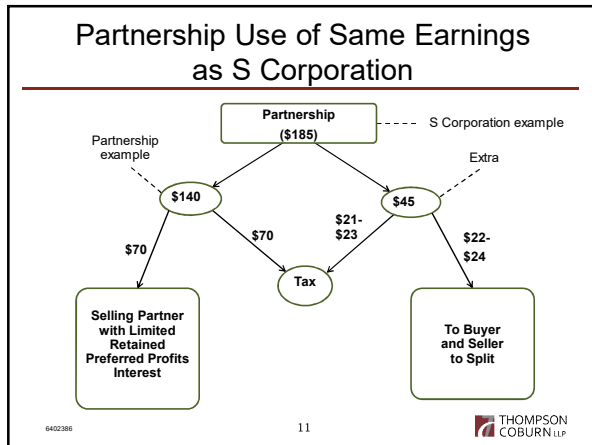
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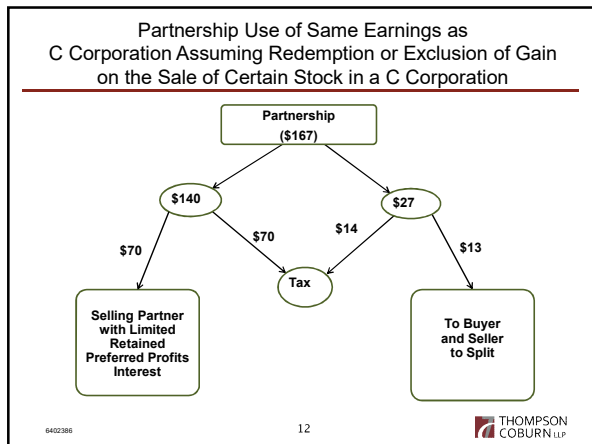
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### Deferred Compensation

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Parts II.Q.1.d. and II.M.4.d.

- Using Nonqualified Deferred Compensation to Facilitate a Sale
- Introduction to Code § 409A Nonqualified Deferred Compensation Rules

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### Deferred Compensation (II.Q.1.c.i., II.M.4.d.)

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- Income Tax Dynamics Are Similar to Partnership Exit Strategy
- Careful in Buy-Sell Agreement Not to Make It a Substitute For Purchase Price
- Balance Sheet Effect (II.Q.8.b.ii.(e). Contrast against profits interests and Code § 736(a)(1) payments)

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### Timeline for FICA and Income Taxation of Deferred Compensation

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II.Q.1.d.iii.

```

    graph LR
      SR[Service Recipient  
(Employer)] -- "Date Earned  
Written Plan" --> SP[Service Provider  
(Employer or  
Independent  
Contractor)]
      SR -- "Date Vested  
FICA" --> SP
      SP -- "Date Paid  
Income Tax" --> SR
  
```

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**Deferred Compensation**

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- Code § 409A Violation Incurs (II.M.4.d.)
  - Acceleration of Income Taxation
  - 20% Penalty
  - Interest on Previously Deferred Tax

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**Deferred Compensation**

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- Written Plan When Legally Binding
- Reasonable Compensation Overlay
- § 409A Applies with Impermissible Triggers, Acceleration, or Re-deferral

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**Deferred Compensation – Permissible Delay (Part II.M.4.d.ii.)**

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- \$150,000 per Year Current Compensation
- \$100,000 Annual Retirement Payments 2020-2029
- End of 2019, Wants to Push Back Retirement

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**Deferred Compensation –  
Permissible Delay (Part II.M.4.d.ii.)**

- Agree in 2019
  - 2020 Work Will Generate \$50,000 Compensation Paid in 2020 and \$100,000 Compensation Paid in 2030
  - 2020 Cash Paid \$150,000
    - \$100,000 Previously Scheduled Deferred Compensation
    - \$50,000 from 2020 Work
  - 2020-2029 Stream of Payments Stays Intact
  - 2030 Retirement Payment Added

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**Profits Interest**

**Part II.M.4.f.**

- No Income on Issuance of Profits Interest
- No Balance Sheet Liability
- No Code § 409A Concerns

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**Profits Interest**

**Part II.M.4.f.**

- Annual Income Taxed to Partner
- Partnership Makes Tax Distributions
- Balance Can Be Paid Whenever Makes Sense for the Business

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
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**Profits Interest**

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- Revaluation Required
- Code § 2701 if Controlled by One Family

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
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**Basis – Inside or Outside?**  
(II.Q.8.e.iii.)

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- “Outside basis” means the basis in your corporate stock or partnership interest
- “Inside basis” means the corporation’s or partnership’s basis in its property
- Death of owner or sale by owner of stock changes outside basis but never inside basis
- Death of owner or sale by owner of partnership interest changes outside basis and will change inside basis if the appropriate election is in place

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
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**Basis Step-Up at Death**

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- When assets are included in the decedent’s estate for estate tax purposes, they receive a new tax basis
- Probate estate, revocable trust, marital deduction trust for surviving spouse all create this results

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### Multiple Depreciation Opportunities

- Original owner depreciates his or her investment
- When first spouse dies, no estate tax on assets passing to surviving spouse, and stepped-up basis obtains depreciation deductions of the new basis
- When surviving spouse dies, possible estate tax, and another stepped-up basis lets children depreciate new basis

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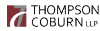
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### Partnership vs. S Corporation

- Some say they are equivalent, but they are not
- Transfer of partnership interest by sale or death allows buyer or beneficiary to get inside and outside basis step-up
- Basis step-up → more depreciation/less gain on sale if partnership sells assets
- S corporation might replicate if it sells all assets and liquidates in the same year

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### Basis Step-Up Issues: Depreciable Real Estate in an S Corporation (Sale to Third Party)

#### Part II.H.8.

#### Sale to Third Party (Zero basis, \$1M value)

Proceeds from sale	\$ 1M
Basis of real estate	\$ <u>0</u>
Gain on K-1	\$ <u>1M</u>

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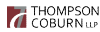
Basis Step-Up Issues: Depreciable Real Estate  
in an S Corporation (Sale to Third Party) (Cont'd)

**Sale to Third Party**  
**(Zero basis, \$1M value)**

Stock basis after death	\$1M
Gain on K-1	<u>\$1M</u>
Stock basis after sale of real estate	<u>\$2M</u>

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Basis Step-Up Issues: Depreciable Real Estate  
in an S Corporation (Sale to Third Party) (Cont'd)

**Sale to Third Party**  
**(Zero basis, \$1M value)**

Liquidation proceeds	\$ 1M
Stock basis	<u>(\$ 2M)</u>
Loss on liquidation	<u>(\$ 1M)</u>

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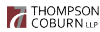
Basis Step-Up Issues: Depreciable Real Estate  
in an S Corporation (Sale to Third Party) (Cont'd)

**Sale to Third Party**  
**(Zero basis, \$1M value)**

Long-term capital gain on K-1	\$ 1M
Long-term capital loss on liquidation	<u>(\$ 1M)</u>
Net long-term capital gain (loss)	<u>\$ 0</u>

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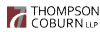
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Basis Step-Up Issues: Depreciable Real Estate in an S Corporation (Sale to Third Party) (Cont'd)

- Sale to Third Party Required If Depreciable or Amortizable Property
- State Income Tax Disconnect

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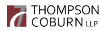
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Which Entity for Which Stage

- Simple LLC (II.E.1., II.E.2.)
  - Start-Up Losses (II.G.3.)
  - Profitable, But Not Overly So
    - Little or No Earnings in Excess of Taxable Wage Base (II.L.1.a.i.) (\$127,200 in 2017)
    - Generous Equipment Write-Offs (II.G.4.)
- Transition to Limited Partnership When Significant Earnings in Excess of Taxable Wage Base

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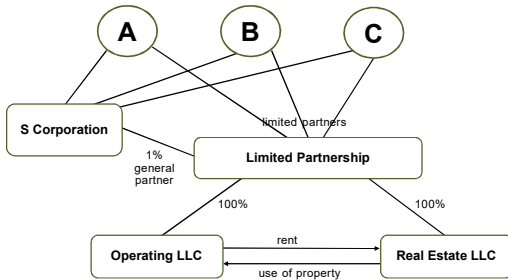
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Recommended Structure Part II.E.



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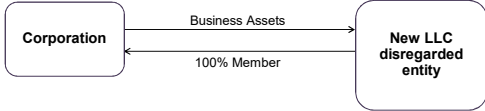
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### Flowcharts: Migrating Existing Corporation into Preferred Structure

#### Part II.E.5.

#### Corporation Forms New LLC – Two Options

##### Direct Formation of LLC (1<sup>st</sup> option)



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### Flowcharts: Migrating Existing Corporation into Preferred Structure

#### Corporation Forms New LLC

##### Direct Formation of LLC (1<sup>st</sup> option)

##### Advantages

- Corporation Can Keep Nonbusiness Assets
- Corporation Can Keep Business Assets That Would Generate Complications if Transferred to the Limited Partnership Structure and Then Had Income Recognition Event
- New LLC Can Stay as a Disregarded Entity for a While as Transition to New Structure and Get Everyone Used to Working in LLC Structure

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### Flowcharts: Migrating Existing Corporation into Preferred Structure

#### Corporation Forms New LLC

##### Direct Formation of LLC (1<sup>st</sup> option)

##### Disadvantages

- Piecemeal Transfer of Assets
- Some Assets Not Readily Transferable

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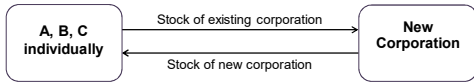
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### Flowcharts: Migrating Existing Corporation into Preferred Structure

Part II.P.3.i.

#### Corporation Forms New LLC

Use F Reorganization to Form LLC (2<sup>nd</sup> option)



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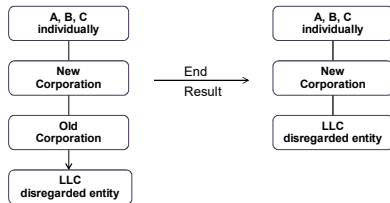
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### Flowcharts: Migrating Existing Corporation into Preferred Structure

Part II.E.5.c.

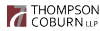
#### Corporation Forms New LLC

Use F Reorganization to Form LLC (2<sup>nd</sup> option)



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### Flowcharts: Migrating Existing Corporation into Preferred Structure

#### Corporation Forms New LLC

Use F Reorganization to Form LLC (2<sup>nd</sup> option)

##### Advantage

- Moves all assets in one fell swoop

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### Flowcharts: Migrating Existing Corporation into Preferred Structure

#### Corporation Forms New LLC

Use F Reorganization to Form LLC (2<sup>nd</sup> option)

#### Disadvantages

- No Selectivity of Retained Assets
- Contribution of Stock of Old Corporation to New Corporation and Merger or Conversion of Old Corporation into New Corporation Need to Be Done at the Same Time
- If S Corporation Involved, New Corporation Does New S Election and Old Corporation Does Qualified Subchapter S Subsidiary Election

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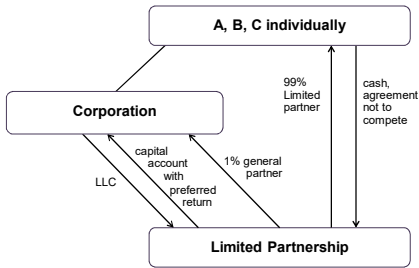
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### Flowcharts: Migrating Existing Corporation into Preferred Structure

#### Migrating LLC to LP: Parts II.E.5., II.Q.7.h.



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### Basis Adjustment (Step-Up) at Death

- When assets are included in the decedent's estate for estate tax purposes, they receive a new tax basis
- Probate estate, revocable trust, marital deduction trust for surviving spouse all create this results

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Multiple Depreciation Opportunities

- Original owner depreciates his or her investment
- When first spouse dies, no estate tax on assets passing to surviving spouse, and stepped-up basis obtains depreciation deductions of the new basis
- When surviving spouse dies, possible estate tax, and another stepped-up basis lets children depreciate new basis

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Estate Taxes

- Federal rate is 40% for estates over \$5,490,000 (indexed annually for inflation)
- States may impose their own tax at various thresholds
- Unlimited marital deduction postpones tax until second death

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Depreciable Property – Example 1

<u>Property</u>	<u>Basis</u>	<u>FMV</u>
Building	\$0	\$8M
Land	\$2M	\$2M
<b>Total</b>	<b>\$2M</b>	<b>\$10M</b>

- Parents transfer property to Children
- First spouse dies and no estate tax is due
- Children sell Property for \$10M
- Children pay capital gain tax of \$2.4M (30% of \$8M)

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Depreciable Property – Example 2

<u>Property</u>	<u>Basis</u>	<u>FMV</u>
Building	\$0	\$8M
Land	\$2M	\$2M
<b>Total</b>	<b>\$2M</b>	<b>\$10M</b>

- A Parent keeps Property
- That Parent dies, property passes to surviving Parent, and no estate tax is due
- Survivor sells Property for \$10M
- Survivor pays no income tax

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Leveraged Transaction – Example 3

<u>Property</u>	<u>Basis</u>	<u>FMV</u>
Building	\$0	\$8M
Land	\$2M	\$2M
<b>Total</b>	<b>\$2M</b>	<b>\$10M</b>

- Parents keep Property
- Parents borrow \$10M against Property and transfer the \$10M using leveraged estate planning techniques
- Parents retain Property subject to \$10M debt
- Parents die and the survivor's estate pays estate tax on the Property's net equity, if any (\$10M property less \$10M mortgage)

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Leveraged Transaction – Example 3

- Building basis is stepped-up from zero to \$8M
  - If building is held and depreciated, basis step-up secures cumulative annual income tax savings of \$3.2M-\$4M (40%-50% of \$8M, depending on entity of owner)
  - If building is sold instead, the approximate capital gain tax savings would be \$2.4M (30% of \$8M) that would have been paid without a basis step-up
- Possible estate tax on any equity may be a small price to pay for income tax savings if building is held and depreciated or sold, whichever applies

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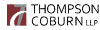


### Leveraged Transaction and Preferred Partnership

- See Example 3
- To protect against future growth in value of the Property, consider a preferred partnership
- Husband and Wife form a partnership that includes a preferred interest and a common interest in exchange for the \$10M Property; preferred interest must represent  $\leq 90\%$  of all partnership equity interests
- Husband and Wife could transfer common interest to Children

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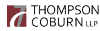
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### Practical Lending Strategy

- Normally, one cannot borrow all of the equity in an asset
- Here, a \$10M loan against the \$10M asset and maintain a security interest in the \$10M proceeds, for \$20M collateral
- When loan proceeds are transferred using advanced estate planning techniques, make sure the security interest stays intact

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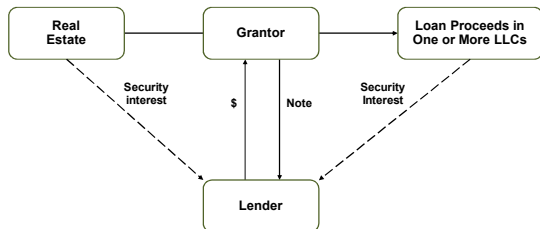
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### Real Estate Equity Strip: INITIAL STRIP (II.H.10.e.i.)



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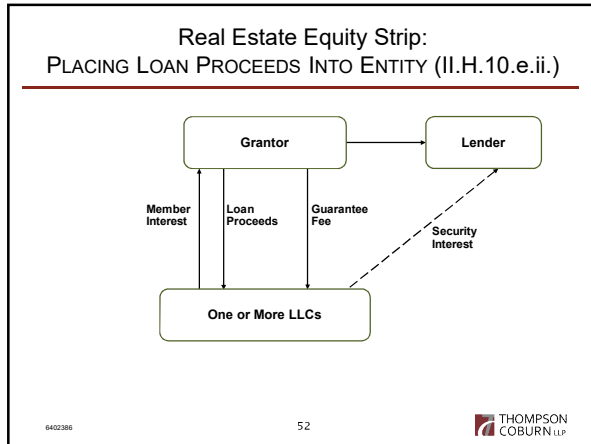
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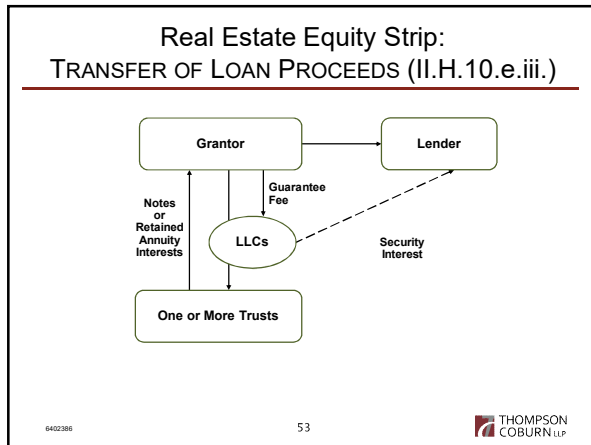
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**Practical Lending Strategy**

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- To the extent possible, make interest payments only, so that the debt can keep the taxable estate low
- Cash flow from real estate would be the primary source of repayments
- Leveraged estate planning techniques also return funds for repayment
- Extract more equity later if possible

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
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**Result of Lending Strategy**

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- Basis step-up
- Minimal estate tax
- Bank's security interest is protected
- Less post-mortem pressure on business client

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
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**Other Exit Strategies**

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- Leasing (Part II.Q.1.b.)
- Personal Goodwill and Covenants Not to Compete (Part II.Q.1.c.)
- Deferring Tax on Lump Sum Payout Expected More than Two Years in the Future (Part II.Q.3.)

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
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**Partnership Distribution vs. Corporation Split-Up: Corporate Division**

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Part II.Q.7.f., II.Q.7.g.

- Code § 355 Requirements
- Tax Effects When Code § 355 Provisions Are Not Met
- Code § 1239: Distributions or Other Dispositions of Depreciable or Amortizable Property (Including Goodwill)

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
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**Partnership Distribution vs. Corporation  
Split-Up: Partnership Redemption**

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Part II.Q.8.b.

- Distribution of Property by a Partnership
- Partnership Redemption – Complete Withdrawal Using Code § 736
- Partnership Alternative to Seller - Financed Sale of Goodwill

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
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**Partnership Distribution vs. Corporation  
Split-Up: Partnership Redemption (Cont'd)**

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- Related Party Sales of Non-Capital Assets By or To Partnerships (Part II.Q.8.c.)
- Partnership Division (Part II.Q.8.d.)
- Transfers of Partnership Interests (Part II.Q.8.e.)

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
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**Life Insurance**

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Part II.Q.4.

- Funding the Buy-Sell (including generational split-dollar)
- Income Tax Trap for Business-Owned Life Insurance
- Establishing Estate Tax Values
- Life Insurance LLC

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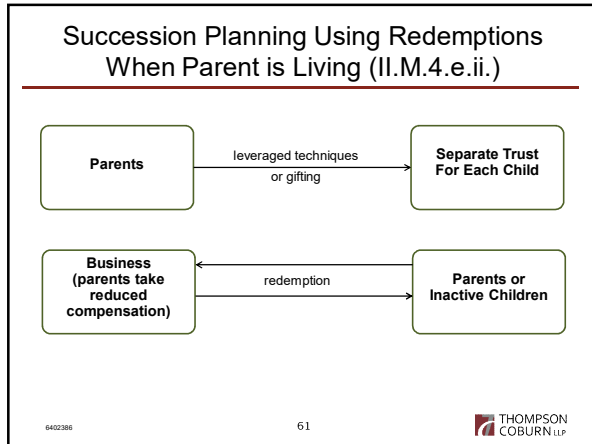
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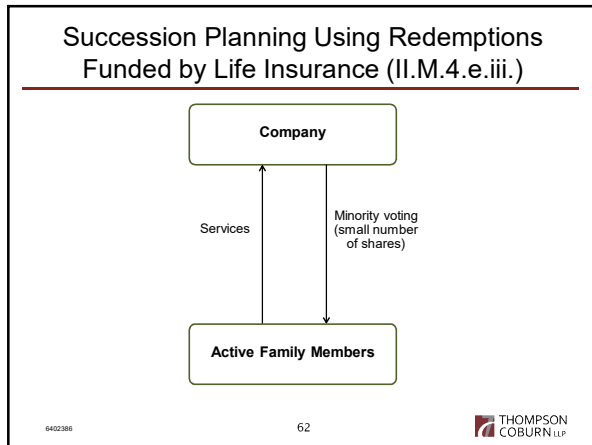
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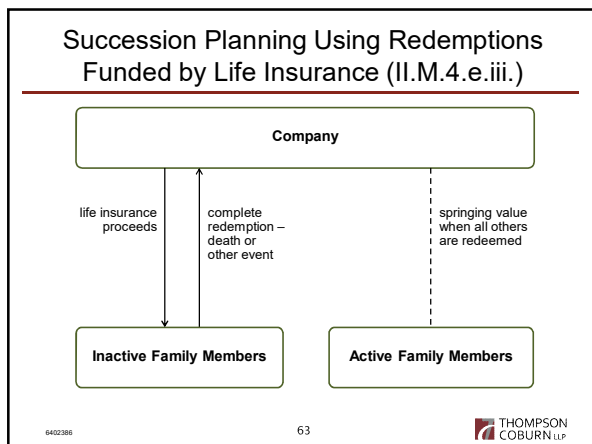
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## Providing Equity to Key Employees

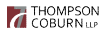
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Parts II.M.4.a.i., II.M.4.a.ii., and II.M.4.e.

- Bonus vs. Equity
- Equity vs. Synthetic Equity
- Issuing Stock to an Employee

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## Additional Equity

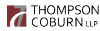
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Parts II.M.4.f. and II.M.4.g

- Issuing a Profits Interest to an Employee
- Options to Acquire Equity

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## Conclusion

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- Email me at [sgorin@thompsoncoburn.com](mailto:sgorin@thompsoncoburn.com) for full searchable PDF of my business structuring materials (over 1,300 pages).
- Free quarterly newsletter includes the most recent version of the PDF. Completing form at <http://www.thompsoncoburn.com/forms/gorin-newsletter> gets you the PDF and newsletter.
- Blog that is less technical is at <http://www.thompsoncoburn.com/insights/blogs/business-succession-solutions>.

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