Top 3 Tax Issues
Before Selling Your Business

Many successful entrepreneurs will one day face the exhilarating opportunity to sell their business and start a new chapter of their life, be it comfortable retirement or moving on to new endeavors. It's very easy in these cases to focus all energy on the transaction itself, on speeding up time and tearing off the calendar pages in anticipation of significant liquid wealth coming your way. However, there are tremendous opportunities that should never be ignored in the months and weeks leading up to the change of control. Here are the top three tax issues to consider before you sell:

1. Reducing Your Tax Rate

Every CEO Founder has at one point or another inquired about the tax impact of their liquidity transaction. The big question goes like this: "When I sell, is it capital gain or ordinary income?" The answer, curiously, is rarely simple and usually a combination of the two. As a rule of thumb, sellers benefit from selling stock (equity) in the business, which ordinarily triggers preferential capital gain tax (at today's maximum rate of 20%). On the contrary, sale of assets is preferred by buyers who normally get a step-up in depreciable or amortizable assets. Unfortunately for sellers, a sale of assets frequently generates ordinary income related to so called "hot assets". As such, CEO Founders need to keep this dichotomy in mind when they negotiate the sale of their business.

2. Choosing State of Domicile Before and After

Timing is crucial for multiple tax issues surrounding liquidity events.

Depending on the type of change of control (asset vs. stock sale), there may be a significant state income tax planning angle for the seller. Asset sales trigger income tax in the jurisdiction where the business is located, while gains of the sale of corporate stock or partnership interest is usually presumed to be taxable only in the state of the owner's residence. It comes as no surprise that plenty of business owners and other wealthy individuals prefer to relocate to low- or no-income-tax jurisdictions before facilitating the sale of their business. Naturally, the states Virginia, Maryland, New York, New Jersey and Massachusetts came up with complex rules and regulations targeting high-net-worth citizens in the attempt to retain income tax jurisdiction over these individuals.

In addition to domicile challenges (i.e. where individual's true home is in any given year), just about every state has codified a concept of so called "statutory residency". It allows tax authorities to subject a non-resident, with a place of abode in their jurisdiction, to state income taxes for the year when they spend a certain number of days in that state.

Even if moving out of state before the sale of business is not possible, or practical, it is nonetheless important to understand these competing state taxation concepts for future years. Many taxpayers choose Florida, Wyoming and other income-tax-free states for retirement, thinking they are avoiding state income taxes. However, many retain a house or a condo when they visit family and friends. Utmost care must be taken to not run afoul of statutory residency rules. In states like New York, New Jersey and California, these taxes can be as high as 10-13%.

3. Saving on Future Gift and Estate Taxes

Oftentimes, there is not a lot of wealth yet amassed before the impending sale of business. It is perfectly natural to not think about wealth transfer until after the liquidity event. After all, what is there to transfer? As it happens, tremendous transfer tax savings can be achieved way before the sale takes place. As a matter of fact, the closer it is to the closing date, the harder it gets to minimize future estate and gift taxes.

The most common techniques to reduce wealth transfer taxes are Grantor Annuity Trusts (GRATs) and Family Limited Partnerships (FLPs).

A GRAT is a vehicle that allows transfer of assets (including partnership interest or stocks) into a trust that pays annuity back to the grantor based on the then value of the assets. Anything remaining within the trust after the annuity period ends gets shifted to future generations, commonly at a nominal tax cost. Further, all future appreciation of these assets within the trust escapes gift and estate taxes.

Another variation of this technique is an installment sale of business interests to a defective grantor trust (a so called IDGT), generally at a nominal or no gift tax cost.

Family Limited Partnerships serve multiple purposes, including creditor protection, family governance and gradual methodical process of transferring management of family finances to future generations. FLPs also allow the grantor to exercise control over the investment management decisions until the time when children or grandchildren are ready to take the reins. On the tax side, this technique minimizes the gifting value of the assets through lack of marketability and lack of alienability discounts. When combined with GRATs or IDGTs, forming a FLP and selling/gifting a part of the soon-to-be-appreciated assets can provide incredible tax minimization opportunities.

In summary, CEO Founders should carefully consider each of these top tax issues that impact decision making before and after the sale of their business.

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