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Transition of the Ownership of a Business by Gift or Sale

by Bradley R. Coppedge

Each of the issues outlined herein come into play whether the business is a C-corporation, S-corporation, or LLC. Many of the issues have equal applicability to a sole proprietorship as well.

There are 3 primary ways to transition a business as the owner considers or plans for retirement:

- (1) no “transition” - shut it down and liquidate assets.
- (2) sell the business to employees or unrelated 3rd party.
- (3) sale, gift or combination of the two to heirs.

In considering an actual transition short of “shutting down the business,” four key issues need to be on the business owner’s mind:

I. Proper operations and documentation prior to a transfer.

The proper operation of the business and documentation of its corporate records and transactions help ensure that you maximize value from a prospective buyer, or minimize potential problems for an heir.

A. Corporate Records – Corporate records include the following: Up-to-date filings with the Secretary of State; annual minutes of the shareholders and Board of Directors of the company; documentation of all significant company action; written employment agreements, leases, etc; arm's-length dealing across the board. Particular care should be taken to keep company funds separate from individual funds and to keep ownership of personal use “property,” i.e. a boat, the beach house, etc. – outside of the company. This is especially important if the business is a C-corporation due to tax consequences of removing such property from the corporation. If money is loaned from the owner to the company, document the loan with a written promissory note and show it on the corporate books. Use market rates of

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interest and provide for payments as scheduled, and make sure said payments are made under the note. The same holds true if money is loaned from the company to a shareholder, though doing so is generally ill-advised, particularly for S-corporations due to the IRS position on “open account” loans to shareholders in s-corporations.

B. Tax Returns – It is essential that corporate tax returns are accurate. It is well known that many businesses, especially smaller ones, fail to report all income. In addition to being fraudulent from a tax law perspective, this failure to report income will hurt you upon a sale. Further, it is all the more important to a buyer that returns are accurate if it is to be a stock sale versus assets sale, due to the potential tax liability that follows the stock. If the tax return doesn't show the income, a buyer won't consider that “missing” income in his offer price.

C. Payroll Taxes – Payroll taxes are NOT dischargeable in bankruptcy. They follow the company, the owner, and in most cases, the officers, even if not owners. The IRS can go after not only the company, but also the owners or officers, and the IRS has no obligation to go after one over the other. It is their choice. There is personal liability for these taxes, and they are generally not limited by a 3-year statute of limitation as most income taxes are (usually because the issue is failure to file the returns at all). In a stock sale, it is “buyer beware.” It is essential that the payroll records are complete and accurate for a business with employees, and this is (or should be) one of the first set of records a purchaser looks at.

D. Tax Structure of the Business – A lot of times this is simply a sophistication issue. Do you have competent legal and accounting help? By “accounting help,” we recommend a CPA, not just a bookkeeper. Are you maximizing income and minimizing expenses from a book perspective of which a potential buyer will see the benefits? Are you funding a retirement plan? Are you taking advantage of some of the perks in the tax code available to businesses? Having these type benefits in place can be an attractive feature in a stock purchase transaction.

E. Marketing – This is not an outline on marketing, but too many business owners tend to “slow down” as they reach a retirement age and approach a sale or other transition of the business. If planning on selling the business, the opposite should occur. Are you maximizing your revenues? If you own a service business, are you soliciting new business? Sending out flyers? Reminder letters? Client newsletters or updates? If you let your business begin to taper off as you near a retirement age or planned transition to a third party by way of sale, you are directly impacting your bottom line sales price.

II. The actual process of planning for transition.

A. Buy-Sell Agreements – Whether transitioning to heirs or employees, a written buy-sell agreement is very important. Such an agreement clearly sets forth the rights and

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obligations of the co-owners, provides a market for the shares/ownership upon death or retirement, and often establishes a price. Depending on the size/value of the business, one may often use a funded buy-sell agreement with “key man” insurance to fund the purchase price of the business from the estate of the owner. This is particularly important in family businesses with multiple lines of ownership. For example: brothers John and Joe Smith may be perfectly content being in business together, but does John want to be in business with Joe’s kids or wife after Joe’s death? Will there be a power struggle? A buy-sell agreement can avoid many of the hassles that can arise after the death of a co-owner.

B. When to give up control? – From an estate planning perspective, there are many tax considerations, particularly if the business is going to the owner’s heirs. Factors to consider include: degree of control the owner wishes to retain and for how long, size of business and value of business. How do you accomplish the transition to the heirs?

- (i) outright retirement and full immediate transfer/transition;
- (ii) transition piece-meal over time and eventually give up control; or
- (iii) transfer all at death, retaining control until the last minute?

C. Estate/Gift Tax Impact – What is the estate/gift tax impact of a transfer to heirs? How do you structure the transition of ownership to heirs?

- (i) part gift/part sale;
- (ii) all gift;
- (iii) all sale; or,
- (iv) a recapitalization?

By gifting incrementally over time, one can minimize estate/gift tax impact. Also, you are more likely to be eligible for estate tax valuation discounts if one is a minority owner by death. Plus, current gifting of ownership removes from the taxable estate not only that portion of value directly attributable to the gift, but also the growth on the same.

A frequent tool used in corporate transition planning (and available in a slightly different format for LLCs) is a recapitalization of the capital stock of the company, converting from one class of stock to 2 classes – voting and non-voting. The founder/owner begins gifting the non-voting stock to begin moving value out of his estate, retaining the voting stock, which is then either sold, gifted, or bequeathed at death to the heir(s). Annual transfers/gifts of stock to heirs can be essential to minimizing taxes.

III. Stock Sale or Asset Sale? There are benefits and downsides to both. A seller generally prefers the tax consequences of a stock sale, which often ensures more of the proceeds

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receive capital gain treatment. On the other hand, a buyer often prefers an asset sale for three (3) main reasons: by buying the assets, (i) the buyer obtains new “basis” in the assets eligible for depreciation, (ii) the buyer has no concern with pending or even unknown tort-type liabilities of the corporation, and (iii) the buyer has no concerns with tax problems of the corporation.

IV. Closing. Due diligence is the key. Competent representation from a legal and accounting perspective is a necessity.

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