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STAFDA **CONSULTANT**

by Ryan **Barradas**

Every business finances its own succession, so it is important to identify the best allocation of the company's cash flow to facilitate the overall objectives of the succession plan.

TAXE$ ON INSIDER TRANSACTIONS

THE GREATEST DISCOUNT ON VALUE

Bob and Matt co-own a manufacturing company in Phoenix, Arizona, that generates nearly $20 million a year in revenue. For the past five years, Matt (Bob's son and a minority five-percent owner) has taken control of the company's day-to-day operations and is destined to succeed Bob as the eventual owner of the business. Bob is interested in monetizing his ownership for an amount that will make him financially secure and would like for Matt to own the business.

Even though there is alignment on who should be the successor owner and how much Bob needs net after-tax to accomplish his goals, there is tremendous uncertainty on what would be the best method for Bob's exit. Much of this uncertainty stems from a failure to understand the tax implications on various insider transactions.

We are confronted with similar fact patterns as Bob and Matt for nearly all of our clients. How much do I need to be financially secure? How can I get enough money to purchase the business from the current owner? How much will I owe in taxes upon sale? What's the most efficient method to monetize my business? All of these questions are ones that need to be addressed when evaluating any insider transaction.

One of the goals of any transaction is for only one layer of tax to be paid. Every business finances its own succession, so we need to identify what is the best allocation of the company's cash flow to facilitate the overall objectives of the succession plan.

Let's take a look at the situation for Bob and Matt; what are some of the ways that Bob could be bought out and Matt could become owner? One option could be that the company bonuses funds to Matt to purchase Bob's shares. This strategy allows Matt to get the cash needed to purchase Bob's interest; however, it also generates more income for the IRS and ultimately puts less after-tax proceeds into Bob's pocket. Matt will have to pay income tax on his bonus from the company and then Bob will pay

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capital gains taxes on the funds received from Matt in exchange for his shares.

Another option would be for the company to redeem Bob's shares, either by way of a seller carry-back note or bank financing. In this option, Bob will pay capital gains taxes on the payments made from the company. This is definitely an improvement over the previous option since there will be less taxes paid, however now the company has to deal with the requirement to make a debt payment every year and comply with any debt covenants.

So the question becomes…are there any methods to transfer one's business to an insider in a tax-efficient manner? We have seen two strategies that are possible solutions, each with their own advantages and drawbacks. First, the succession plan could involve a Supplemental Executive Retirement Plan (SERP) and use of the exiting owner's unified credit (estate and gift tax exemption).

A SERP is a "promise to pay" deferred compensation to an executive for their past service. A company will enter into a plan agreement to stipulate the timing and amount of the deferred compensation payments as well as what happens on various triggering events (death, disability, etc.). These future payments represent a liability on the company's financial statements that lowers the fair market value of the business.

Depending on the amount of the discount, this could allow Bob to use his unified credit to gift his business interest to Matt. From an income tax perspective, Bob will recognize the payments as ordinary income and the company will recognize an income tax deduction when the SERP payments are made, so this strategy results in only one layer of tax.

However, the primary drawback of a plan like this is the restrictions that come into play since SERPs are an ERISA plan governed by 409A. Payments must be made according to the plan document or the employee and company will face significant tax consequences and penalties.

Another tax-efficient strategy is by using a stock redemption plan governed by section §301 of the Internal Revenue Code. This Code section states a redemption will be treated as a dividend for tax purposes as opposed to a sale and exchange, subject to certain requirements. For an S Corporation, this means that the redemption proceeds will be paid out of the company's AAA (Accumulated Adjustments Account).

Since an S Corp's AAA represents previously taxed funds that have not been distributed to the company's shareholders yet, these redemptions can be made tax-free. Each year, the company will redeem Bob's shares out of the company's available cash flows.

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This strategy offers tremendous flexibility, as redemptions are only made if the company generates enough cash flow each year; therefore, no cash flow equals zero redemption for that year. The company is then not burdened by any bank financing to facilitate the redemption. As long as the redemption proceeds don't exceed 20 percent of a shareholder's ownership in any given year, this strategy can preserve its tax-efficient status.

The chart below illustrates the four different options that we have discussed in this article:

Taxes on Insider Transactions - $10 Million Purchase Price

	OPTION #1: Bonus Funds to Employee & Purchase Shares	OPTION #2: Company Redeems Shares	OPTION #3: SERP & Gift	OPTION #4: §301 Stock Redemption
Purchase Price	$ 10,000,000	$ 10,000,000	$ 10,000,000	$ 10,000,000
Taxes Owed*	$ (5,875,000)	$ (2,500,000)	$ (4,500,000)	$ -
Net After Tax Proceeds	$ 4,125,000	$ 7,500,000	$ 5,500,000	$ 10,000,000

*Taxes owed includes ordinary income (45%) and/or capital gains (25%) taxes where applicable.

As you can see, the impact of taxes on insider transactions can be substantial. Depending on the strategy used, the net after-tax proceeds to Bob range from $4.125 to $10 million. By understanding the income taxation of various methods of exit and determining the net after-tax proceeds for the exiting shareholder, it becomes clear how the shareholder should monetize their interest. By selecting the appropriate method of exit, the departing shareholder will have a higher likelihood of moving from "I need more" to "I have enough" in terms of accomplishing his financial security objectives.

We at WealthPoint are always available to help STAFDA members evaluate succession planning strategies and better understand the tax implications the plan will have for all stakeholders. CS

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