Tax Planning for the Sale of a Business

Presented by

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Overview

1. Build Back Better Act – *Rate Hike Fears*
2. Tax Incentives for Equity Investments in Small Business Corporations
3. Installment Sales
4. Incomplete Gift Non-grantor Trusts
5. Charitable Remainder Trusts

Important Topics NOT Covered Today

- Ordinary Income v. Capital Gain
- “Double” Taxation
- Stock v. Asset Sales
- Tax-free Reorganizations
- Purchase Price Allocations

Build Back Better Act

Rate Hike Fears

Individuals, Trusts & Estates

- **State & Local Tax Deduction**
  - Increase the cap from \$10,000 to \$80,000
  - Increase effective from 2022 – 2030
  - The cap will not sunset in 2026 as planning
  - The cap will revert to \$10,000 for 2031

Individuals, Trusts & Estates

- 3.8% Net Investment Income Tax (NIIT) expansion
  - Expands the NIIT to cover income derived in the ordinary course of a trade or business for high income taxpayers
  - Does not apply to income on which FICA is already imposed
  - Applies after 12/31/21

CLOSES THE S-CORP LOOPHOLE

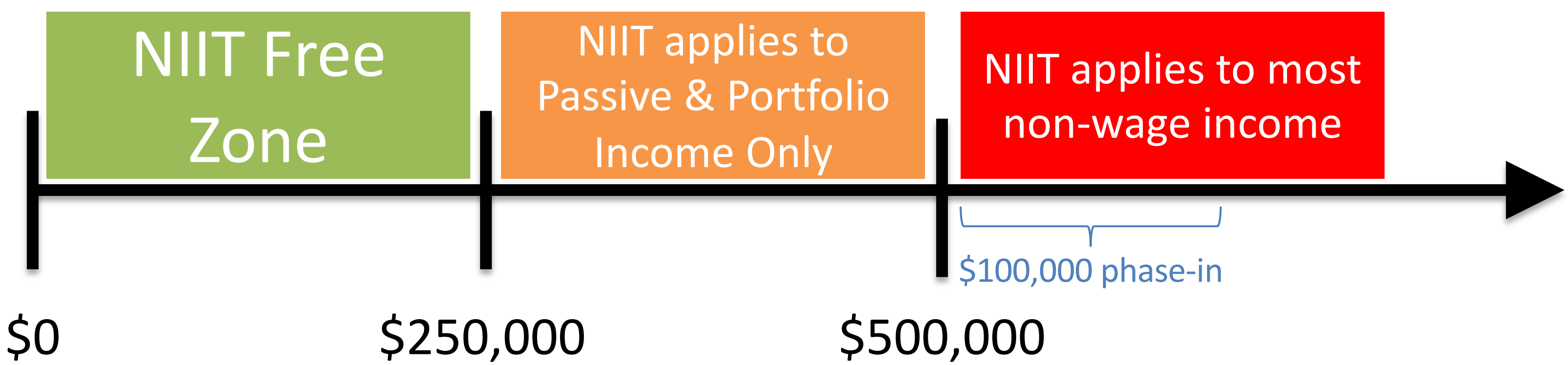
Expanded NIIT Threshold	
Married Filing Jointly (MFJ)	$500,000
Head of Household (HoH)	$400,000
Single	$400,000
Married Filing Separately	$250,000
Estates & Trusts	$400,000

NOT INDEXED FOR INFLATION

REAL ESTATE PROFESIONAL TREATMENT UNCLEAR

Individuals, Trusts & Estates

3.8% Net Investment Income Tax (NIIT) expansion



MFJ

Individuals, Trusts & Estates

- Excess Business Loss Limitation
  - Section 461(l) limits pass-through business net losses which can offset non-business income to $250,000 (or $500,000 MFJ) (2021 limit)
  - This was added by the TCJA and set to sunset in 2025 (note, the CARES Act modified the effective date)
  - This legislation would permanently apply the limitation beyond 2025

Individuals, Trusts & Estates

- High Income Taxpayer Surcharge
  - A surcharge equal to 5% of excessive Modified AGI
    - ➢ The AGI threshold is $10,000,000 ($5,000,000 MFS)
    - ➢ The AGI threshold is $200,000 for trusts & estates
  - A surcharge equal to 3% (8% total) of excessive Modified AGI
    - ➢ The AGI threshold is $25,000,000 ($12,500,000 MFS)
    - ➢ The AGI threshold is $500,000 for trusts & estates
  - Modifications to AGI include a reduction for investment interest
  - NO SUNSET date

Individuals, Trusts & Estates

- Section 1202 Modifications
  - Limit gain exclusion to 50% for taxpayers with income in excess of $400,000
  - Note, there is also an AMT adjustment to contend with

This change would effectively eliminate the 100% exclusion.

Tax Incentives for Equity Investments in Small Business Corporations

Tax Incentives for Equity Investments in Small Business Corporations

- **IRC § 1244** - Ordinary losses
- **IRC § 1202** - Partial exclusion for gain
- **IRC § 1045** - Rollover of gain

IRC § 1244
Ordinary Losses

- Available for individuals and partnerships to convert capital loss into ordinary loss
- Maximum amount for any taxable year:
  - $50,000
  - $100,000 for joint filers
- Losses in excess of income can be carried forward under § 172

26 U.S.C. § 1244

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Ordinary Losses

- 1244 Stock Definition
  - Additional requirements for stock issued before 11/6/78
  - Stock issued before 7/18/84 must be common stock; can be preferred stock thereafter as well
  - Stock in a domestic corporation
  - at the time such stock is issued, such corporation was a small business corporation
  - such stock was issued by such corporation for money or other property (other than stock and securities)
  - such corporation, during the period of its 5 most recent taxable years ending before the date the loss on such stock was sustained, derived more than 50 percent of its aggregate gross receipts from sources other than royalties, rents, dividends, interests, annuities, and sales or exchanges of stocks or securities

26 U.S.C. § 1244

Ordinary Losses

- Small business corporation definition:
  - The aggregate amount of money and other property received by the corporation for stock, as a contribution to capital, and as paid-in surplus, does not exceed $1,000,000.
  - the amount taken into account with respect to any property other than money shall be the amount equal to the adjusted basis to the corporation of such property for determining gain, reduced by any liability to which the property was subject or which was assumed by the corporation

26 U.S.C. § 1244

Ordinary Losses

- Individuals
  - Does not include trusts or estates
  - More restrictive than 1045 or 1202 in this respect
- Partnerships
  - Trusts & estates partners are not eligible; only individuals
  - Individuals must be partners at the time the stock is issued to the partnership to be eligible
  - Loss deduction limited to the partner’s distributive share at the time the loss is sustained

26 U.S.C. § 1244

IRC § 1202
Partial Exclusion For Gain

- Taxpayers (other than corporations) may be able to exclude certain percentages of gain on qualified small business stock provided the stock meets the following requirements:
  - Dollar limitation on the amount of gain
  - The stock must be issued after August 9, 1993
  - Must be a C corporation
  - Taxpayer must have acquired the stock at its original issue
  - The stock must be held for more than five years
  - The corporation must at all times have gross assets of $50 million or less
  - Must be an active business
  - Must be a qualified trade or business

26 U.S.C. § 1202

Partial Exclusion For Gain

Acquisition Period	Exclusion Amount
Aug 9, 1993 - Feb. 17 2009	50%
Feb. 18, 2009 – Sept. 27, 2010	75%
Sept. 28, 2010 and after	100%

Note, there is a 60% exclusion for “empowerment zone businesses”

26 U.S.C. § 1202

Partial Exclusion For Gain

Acquisition Period	AMT Add-Back Amount
Aug 9, 1993 - May 6, 2003	42%
May 6, 2003 – Sept. 27, 2010	7%
Sept. 28, 2010 and after	0%

26 U.S.C. § 1202

Partial Exclusion For Gain

- The first time the exclusion is claimed it is capped to the greater of:
  - $10,000,000 ($5,000,000 for a married filing separately taxpayer)
  - **Ten times** the aggregated adjusted basis of the corporations qualified stock disposed by the taxpayer during the tax year
- The $10,000,000 limit is reduced in following years by the amount claimed in previous years
- Adjusted basis is determined without considering any additions to basis after the stock was issued

26 U.S.C. § 1202(b)

Partial Exclusion For Gain

- The stock must be in a C corporation
  - “Must be a C corporation during substantially all of the taxpayer’s holding period”

26 U.S.C. § 1202(c)

Partial Exclusion For Gain

- Qualified small business
  - The corporation must at all times have aggregate gross assets of $50 million or less
  - the term "aggregate gross assets" means the amount of cash and the aggregate adjusted bases of other property held by the corporation
  - the adjusted basis of any property contributed to the corporation shall be determined as if the basis of the property contributed to the corporation were equal to its fair market value as of the time of such contribution
  - members of a parent-subsidiary controlled group (using a more-than-50% ownership test) are treated as a single corporation

26 U.S.C. § 1202(d)

Partial Exclusion For Gain

- Active business requirement
  - at least 80 percent (by value) of the assets of such corporation are used by such corporation in the active conduct of 1 or more qualified trades or businesses

26 U.S.C. § 1202(e)

Partial Exclusion For Gain

- Working capital
  - Assets held as part of the reasonable working capital needs of the business shall be treated as used in the active conduct of a trade or business
  - Assets held for investment and are reasonably expected to be used within 2 years to finance research and experimentation in a qualified trade or business shall be treated as used in the active conduct of a qualified trade or business
  - in no event may more than 50 percent of the assets of the corporation qualify as used in the active conduct of a qualified trade or business

26 U.S.C. § 1202(e)(6)

Partial Exclusion For Gain

- Qualified trade or business requirement
  - any trade or business other than—

(A) any trade or business involving the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset of such trade or business is the reputation or skill of 1 or more of its employees,

(B) any banking, insurance, financing, leasing, investing, or similar business,

(C) any farming business (including the business of raising or harvesting trees),

(D) any business involving the production or extraction of products of a character with respect to which a deduction is allowable under section 613 or 613A, and

(E) any business of operating a hotel, motel, restaurant, or similar business.

26 U.S.C. § 1202(e)(3)

Partial Exclusion For Gain

- Eligible corporations
  - any domestic corporation; except that such term shall not include—

(A) a DISC or former DISC,

(B) a corporation with respect to which an election under section 936 is in effect or which has a direct or indirect subsidiary with respect to which such an election is in effect,

(C) a regulated investment company, real estate investment trust, or REMIC, and

(D) A cooperative

26 U.S.C. § 1202(e)(4)

Partial Exclusion For Gain

- Maximum real estate holdings
  - No more than 10 percent of the total value of its assets consists of real property which is not used in the active conduct of a qualified trade or business.
  - The ownership of, dealing in, or renting of real property shall not be treated as the active conduct of a qualified trade or business

26 U.S.C. § 1202(e)(7)

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IRC § 1045
Rollover of Gain

- Gain from the sale of qualified small business stock held by a taxpayer other than a corporation for more than six months is only recognized to the extent such sale exceeds the cost of any qualified small business stock purchased by the taxpayer within 60 days
- “Qualified small business stock” has the meaning given such term by section 1202(c).
- The taxpayer’s basis in the replacement stock equals its purchase price less the amount of rollover gain

Reporting Income from an Installment Sale

Reporting Income from an Installment Sale

- **IRC § 453** - Installment Method
  - Installment sale defined
    - The term "installment sale" means a disposition of property where at least 1 payment is to be received after the close of the taxable year in which the disposition occurs.
    - The term "installment sale" does not include dealer dispositions or a disposition of personal property of a kind which is required to be included in the inventory of the taxpayer if on hand at the close of the taxable year.

26 U.S.C. § 453(b)

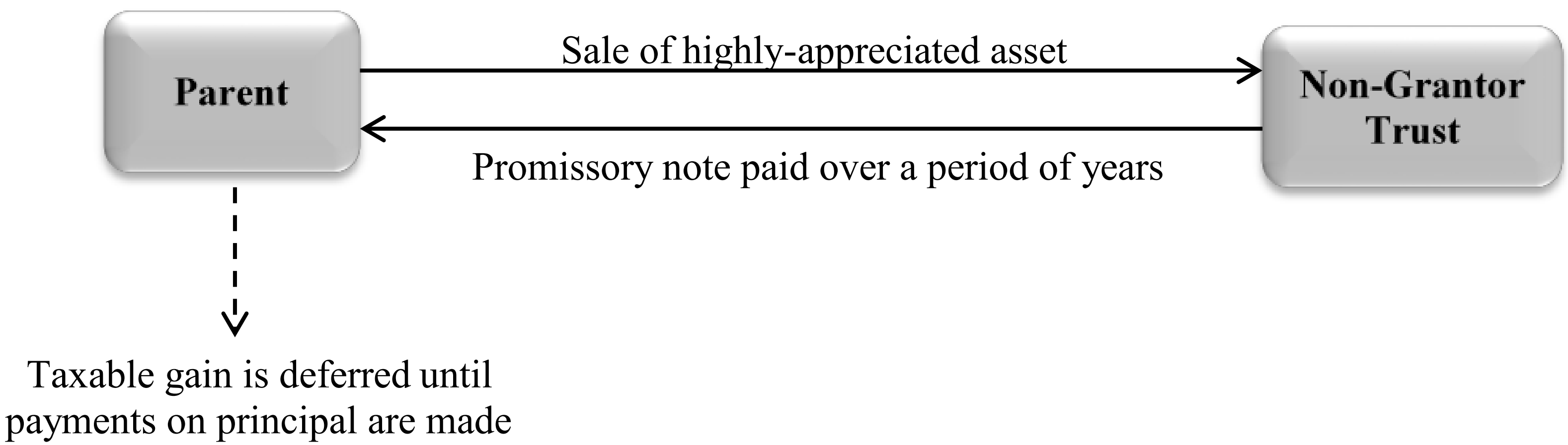
Reporting Income from an Installment Sale

- **IRC § 453** - Installment Method
  - Installment method defined
    - ➢For purposes of this section, the term “installment method” means a method under which the income recognized for any taxable year from a disposition is that proportion of the payments received in that year which the gross profit (realized or to be realized when payment is completed) bears to the total contract price.

26 U.S.C. § 453(c)

Reporting Income from an Installment Sale

- **IRC § 453** - Installment Method



26 U.S.C. § 453(c)

Reporting Income from an Installment Sale

- **IRC § 453** - Installment Method
  - Election Out
    - ➢ Taxpayer can elect out of the installment method
    - ➢ Must be made on the return of the taxable year in which the disposition occurs
    - ➢ IRS must consent to revoking the election

26 U.S.C. § 453(d)

Reporting Income from an Installment Sale

- **IRC § 453** - Installment Method
  - Second dispositions by related persons
    - Must be made on the return of the taxable year in which the disposition occurs
    - IRS must consent to revoking the election

26 U.S.C. § 453(e)

Reporting Income from an Installment Sale

- **IRC § 453** - Installment Method
  - Second dispositions by related persons

    Example 1. Parent (P) sells Greenacre, with a basis of $500,000 and FMV of $1,000,000 to a trust for P's children (CT). P takes back a 10-year note calling for 10 annual principal payments of $100,000 and adequate stated interest. CT's basis in Greenacre is $1,000,000, the amount of the note. In the first two years, CT makes payments of $100,000 to P and P recognizes $50,000 of gain on each payment. After making the second payment, T sells Greenacre to an unrelated party for $1,000,000 and recognizes no gain because CT's basis is equal to the selling price. CT has cashed out the full $1,000,000 value of Greenacre even though P has paid tax on only $100,000 of the gain. T will continue to pay off the note over the next eight years, gaining a substantial timing advantage.

26 U.S.C. § 453(e)

Reporting Income from an Installment Sale

- **IRC § 453** - Installment Method
  - Interest on Deferred Tax Liability
    - ➢Interest is generally due on the deferred tax liability of outstanding installment agreements in excess of $5,000,000
    - ➢The deferred tax liability generally equals 20% x unrecognized gain
    - ➢The Underpayment Rate (currently 3%) applies

26 U.S.C. § 453A

Reporting Income from an Installment Sale

Bracket Management

TOP OF EACH CAPITAL GAINS BRACKET					
	S	MFJ/QW	MFS	HOH	T&E
0%	$ 41,675	$ 83,350	$ 41,675	$ 55,800	$ 2,800
15%	$ 459,750	$ 517,200	$ 258,600	$ 488,500	$ 13,700
20%					

AMT	2021	2022
Single or Head of Household	$73,600	$75,900
Married Filing Jointly	$114,600	$118,100
Begin of Phaseout, Single or HoH	$523,600	$539,900
Begin of Phaseout, MFJ	$1,047,200	$1,079,800

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Reporting Income from an Installment Sale

Bracket Management

- Installment sale benefits
  - Avoids a "spike" in income and allows it to be spread-out
  - **In the extreme, it can convert long-term capital gains taxed at 23.8% to 0%**

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Incomplete Gift Nongrantor Trusts

Incomplete Gift Nongrantor Trusts

- **Potential Opportunity:**
  - Resident of state with state income tax contributes low basis business equity interest to a NING Trust.
  - Trustee later sells the interest.
  - State income tax may be avoided.

Incomplete Gift Nongrantor Trusts

- **NING Trust**
  - Non-grantor trust for income tax purposes
    - Distribution Committee made up of adverse parties
  - Incomplete gift for gift tax purposes
    - Retained testamentary power of appointment
    - Retained non-fiduciary inter vivos power of appointment
    - Chief Counsel Advice Memorandum 201208026

Incomplete Gift Nongrantor Trusts

- **The NING Trust doesn't work if you can't work around the resident's state income tax rules**
  - Source income
  - Non-source income
    - ➢Grantor's residency?
    - ➢Administered in state?
    - ➢Resident trustee?
    - ➢Resident beneficiary?

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Incomplete Gift Nongrantor Trusts

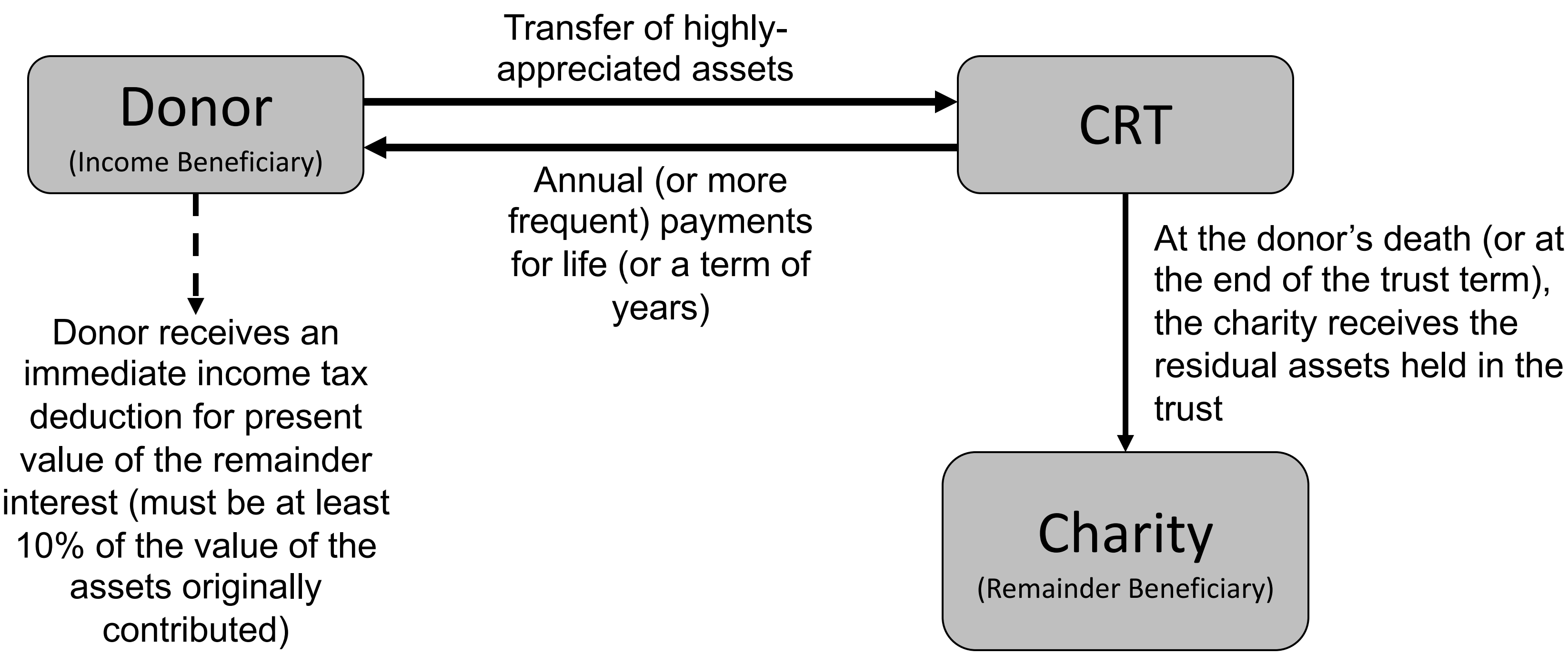
- **Numerical Example – Low Basis Asset**
  - Example using round numbers
  - Assumptions
    - Business will be sold for $5,000,000
    - Income tax basis is $0
    - Federal capital gains rate is 20% plus 3.8% Obamacare
    - *State capital gains rate is 10%*
    - Disregard Federal income tax deduction for state income tax paid
  - Using NING Trust
    - $5,000,000 sales proceeds
    - $1,190,000 Federal income tax (i.e., $5,000,000 times 23.8% tax)
    - No state income tax (would have been $500,000 without the NING)
    - $3,810,000 after-tax proceeds (would have been $3,310,000 without the NING)

Charitable Remainder Trusts

Charitable Remainder Trusts

- **Potential Opportunity:**
  - Charitably inclined taxpayer contributes a low basis business equity interest to a CRT.
  - Trustee later sells the interest tax-free.
  - Grantor (or other beneficiary) receives a series of payments which are taxed as paid.
  - Income tax is deferred.
  - State income tax may be avoided.

Charitable Remainder Trusts



Charitable Remainder Trusts

- **Charitable Remainder Annuity Trust (CRAT)**
  - The beneficiaries receive a fixed percentage of the initial trust value or a stated amount annually or more frequently.
  - The amount paid doesn't change from year-to-year.
  - The annual payment must be 5-50% of the fair market value of the assets at the time of contribution.
  - The term of the annuity can be:
    - For a term up to 20 years,
    - Over the life of the annuitant(s),
    - Over the shorter of the two, or
    - Over the longer of the two.

Charitable Remainder Trusts

- **Charitable Remainder Unitrust (CRUT)**
  - Income beneficiaries receive a stated percentage of the trust's assets revalued each year.
    - ➢ The distribution will vary from year-to-year depending on the investment performance of the trust assets and the amount withdrawn.

Charitable Remainder Trusts

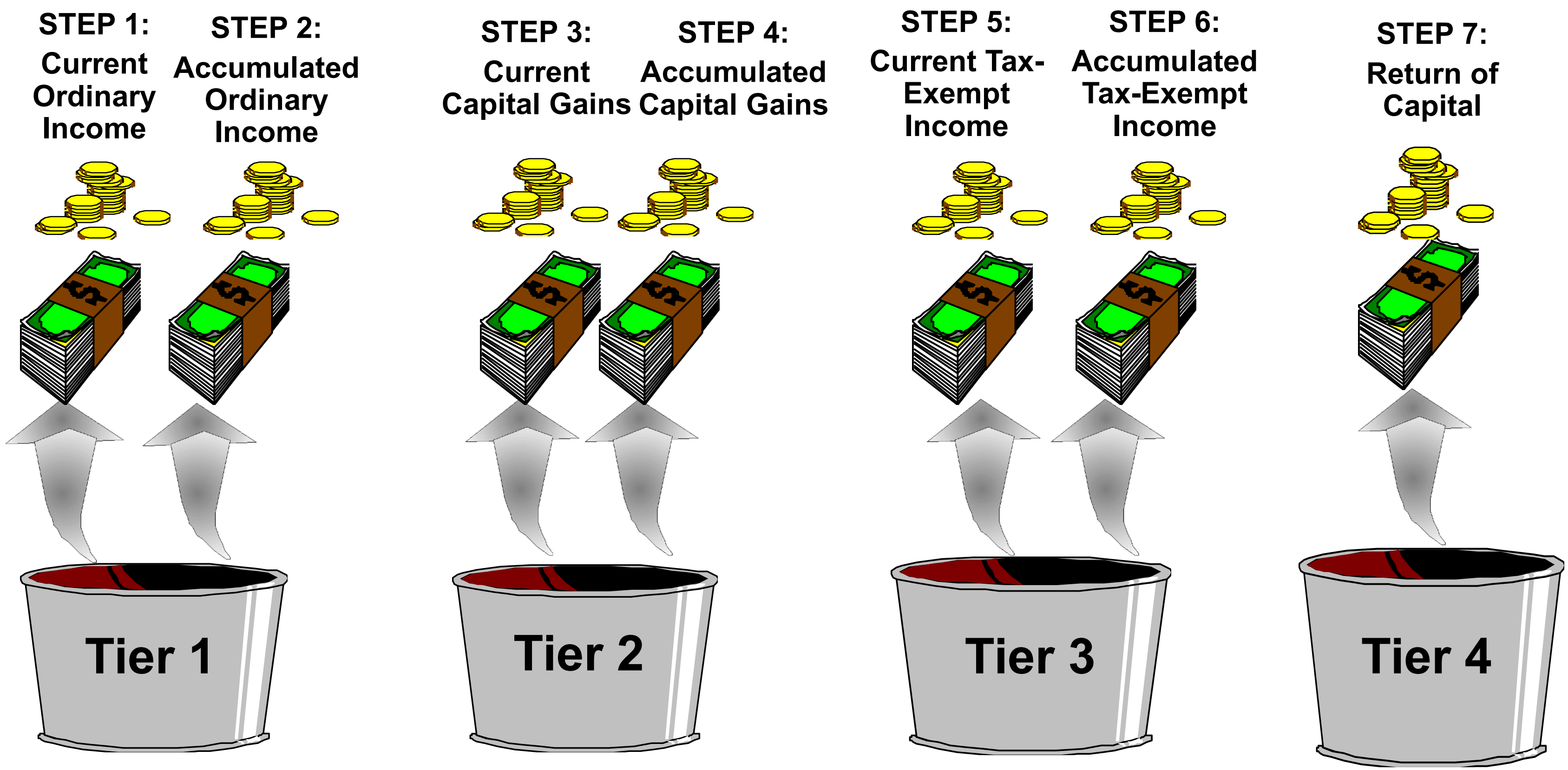
- **Taxation of the Donor & Trust**
  - Donor generally does not realize gain or loss when property is transferred to the trust
  - The donor generally will not realize gain or loss if and when the transferred assets are subsequently sold by the trustee of the CRT*
  - Distributions in kind are treated as a sale of the property distributed, resulting in gain recognition by the CRT. Treas. Reg. §1.664-1(d)(5).

*Need to consider the binding commitment issue. See Rev. Rul. 78-197.

Charitable Remainder Trusts

- **Taxation of Distributions**
  - The character of income received by the recipient is subject to and controlled by the tier rules of IRC §664(b):
    - First, distributions are taxed as ordinary income
    - Second, distributions are taxed as capital gains
    - Third, distributions are taxed as tax-exempt income (e.g. municipal bond income)
    - Finally, distributions are assumed to be the non-taxable return of principal

Charitable Remainder Trusts



Charitable Lead Trusts

Inter Vivos CLAT

Overview

- A Charitable Lead Trust (CLT) is a split interest trust consisting of an income interest and a remainder interest.
- During the term of the trust, the income interest is paid out to a named charity.
- At the end of the trust term, the remainder (whatever is left in the trust) is paid to non-charitable beneficiaries (e.g. children of the donor) that have been designated in the trust document.
- The valuation method for gift tax purposes generally understates the true future value of the remainder interest making this an attractive plan for those charitably inclined

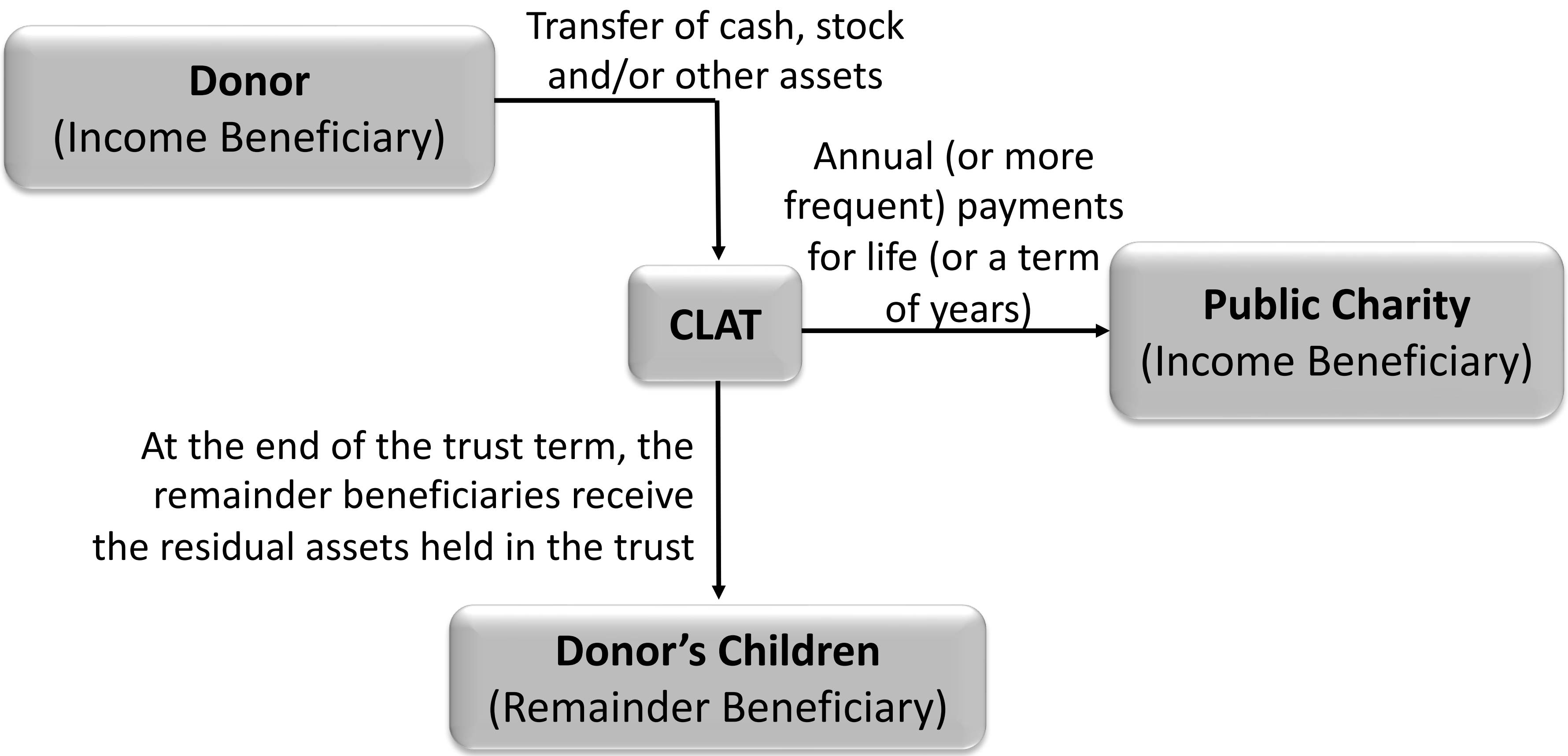
Inter Vivos CLAT

Overview

- The charitable beneficiary receives a stated amount of the initial trust assets each year
  – The amount received is established at the beginning of the trust and will not change during the term of the trust regardless of investment performance
  – unless inadequate investment performance causes the trust to run out of assets

Inter Vivos CLAT

Overview



End

Questions