

How Today's Environment Affects Your Exit Strategy

The last of a two-part series

At some point — after years of hard work building a business — many business owners begin to think, “What next?” Thinking about the future can take many forms.

- Do I expand and continue to grow the business?
- Should I sell the business to a third party?
- Is there a family member capable of taking over?

Pursuing these options requires advanced planning, and today's economy presents unique tax opportunities.

Tax Implications in Today's Environment

It's no surprise that tax rates will soon increase. As a result, entrepreneurs will face complex decisions about the structure of their business, including:

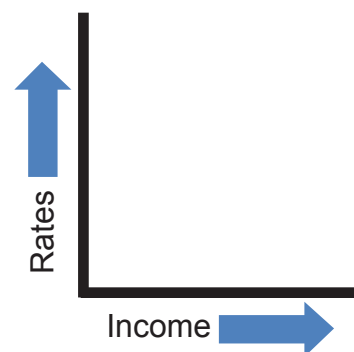
- Tax on annual business income
- Tax on a potential future business sale
- Tax on the transfer of business ownership to family members (estate and gift tax)

Tax on annual business income

During most of the recent past, Congress established the maximum individual income tax rate at or below the maximum corporate tax rate. As a result, entrepreneurs have selected partnerships, LLCs, and S corporations (known as “pass-thru” entities) as their operating entities of choice. This allowed all business income (whether paid to the owners or not) to be taxed at individual income tax rates.

Beginning in 2011 the maximum individual tax rate is scheduled to return to 39.6% as compared to the 35% maximum rate on corporate income. In addition, Congress is currently considering a tax surcharge (to help fund health insurance) on individual incomes that exceed \$350,000. This surcharge could be as high as 5.4% and bring the total highest rate of income tax on individuals to 45%.

With this in mind, entrepreneurs could likely find themselves looking to migrate to the corporate form of operating their business in order to stay at the 35% tax rate on business earnings. However, this decision will need to be evaluated carefully by taking into consideration the possibility of a future business sale.



Tax on a potential future business sale

The legal structure around a future business sale may take many different forms, which makes the tax planning more complex. The most common situation usually includes the purchaser buying the assets (tangible and intangible), including the rights to operate the business rather than the business entity itself. Purchasers want to avoid any unknown liabilities that might arise after the sale that could be associated with the former owner's business entity.

The sale of business assets for a corporation has two distinct tax disadvantages:

- Corporations do not have lower tax rates for capital gains
- Shareholders of the corporation will pay tax a second time on the distribution of sales proceeds

Tax consequences for an asset sale by a corporation versus a partnership or LLC will almost always yield a lower tax for the partnership or LLC structure. Although

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a complex analysis, oftentimes the amount of reduced tax can be significant. Recent examples reflect that such tax for a partnership or LLC may be only 65% of the amount of tax incurred with the corporate structure.

As a result, the type of entity in the current tax environment is complex and very dependent on the future plans for the business.

Tax on the transfer of business ownership to family members (estate and gift tax)

The estate and gift tax system focuses on the transfer of wealth from one generation to another, and it is completely separate from the income tax system. Gift tax occurs in a lifetime transfer, and estate tax pertains to transfer after death. If the business owner wants a child(ren) or other younger family member(s) to take control and operate the business, now is an ideal time to start the process because:

- Business values are low. In the current business climate values of even the most successful businesses are low, and therefore ownership may be transferred with significant estate and gift tax savings.
- Congress has been considering changes to rules used in valuing businesses for the purpose of transfers and the impact of estate and gift tax. If these changes are implemented the tax cost of transferring these types of assets will substantially increase.
- Low interest rates allow an entrepreneur to finance an inter-family sale of a business at a very low interest rate for the related party purchaser.

Recap

Today's economy presents unique tax opportunities for business owners. Being proactive and planning ahead is to your advantage.

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