Eventual M&A Exit Strategy? - A Few Estate and Tax Planning Considerations

by Brooke Hollis

Most privately held businesses will eventually transition to some form of new ownership. However, owners often fail to take the time to fully assess vehicles that exist to optimize tax treatment and to effectively protect or transfer assets. Working with a team well in advance of a sale, it is often possible to combine tax/estate planning with M&A value-improvement strategies to enhance ultimate after-tax benefits. Even if a transaction is a more near-term event, there are strategies that can be considered. The key is not to wait until the last minute.

Wills and Trusts

A well-drafted will and trust will provide a much better chance of realizing your actual intentions after your death. One of the most common enhancements to a will is the use of the so-called A/B Trust. These allow husband and wife to take full advantage of methods to minimize their federal estate tax amounts – effectively doubling the amounts available versus using the unlimited marital deduction until the death of the second spouse. Another advantage of a trust is the so-called Living Trust, which if properly drafted, executed and funded, generally avoids putting the estate through probate. At this writing, there are a variety of initiatives that could change, so as always, it is important to evaluate the most current situation with a qualified tax advisor.

Asset Protection

In our litigious and divorce-prone society it is all-too-easy for multi-million dollar judgments or settlements to wipe-out a significant portion of accumulated wealth. A simple and inexpensive asset-protection vehicle that many overlook is the Umbrella Liability Policy. Often for a few hundred dollars annually, a $2 million or larger umbrella policy can provide a first level of personal liability protection. A number of the more complex vehicles noted below offer additional layers of asset protection in addition to estate tax planning advantages.

Corporate Form Issues and Planning Strategies

Many firms are set up as "S" Corporations (S-Corps). More frequently firms are being set up as Limited Liability Corporations (LLCs). However, quite a number are still set up as "C" Corporations (C-Corps).

In the case of an asset sale of a C-Corp, a "double" taxation occurs since proceeds are taxed first at the corporate level and then again at the stockholder level. Since most buyers prefer an asset transaction rather than a purchase of stock for liability, and for other reasons, this can pose a problem for sellers. Therefore, it is advisable to have a clean overall operation with audited financial statements well in advance of a sale if you have a C-Corp. While still difficult, this may help allay some buyer concerns and may contribute to their willingness to consider a purchase of company stock.

Many owners believe that changing their election to an S-Corp will solve the C-Corp tax problem. Unfortunately, this does not work. Simplifying the tax details, because of "built-in gains" and IRS rules, if a company is sold within 10 years after the change and assets are sold, the transaction would be taxed effectively as if it were still a C-Corp. Given the substantial difference between current 15% long-term capital gains, tax on the sale of capital assets for the S-Corp and the combined corporate level tax and shareholder level tax for an asset sale with either a C-Corp or recently converted C- to S-Corp, this is certainly worth assessing.

It is possible to take steps to mitigate the tax impact somewhat by having a third-party valuation of the company at the time of the election to change. This way, subsequent gains in value will not be subject to the same tax treatment as the baseline value.

More Advanced Techniques

There are a number of innovative estate planning techniques that have been developed over the years which can offer substantial benefits to the owner and his/her beneficiaries. They include variations on: Irrevocable Life Insurance Trust, Charitable Remainder Trusts, Family Limited Partnerships, LLC variations on the FLP, Grantor Retained Annuity Trusts, Spousal Trusts, Dynasty Trusts, QTIP, and other tools. Because of discounts associated with minority interests or limited marketability, it is sometimes possible to transfer interests to heirs at a discount, allowing for appreciation in value outside of the estate. Many of these vehicles also afford additional asset protection. With some, it may be possible to retain some level of control over the assets into the future.

This article is intended only to introduce a few basic concepts that company owners may wish to explore in more detail. We encourage clients to evaluate a variety of strategies as part of the M&A planning process. However, because of the many complex and evolving tax and legal issues, anyone considering these or similar ideas should not proceed without retaining expert tax, financial planning and legal counselors who focus in these areas.

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