

## Keys to Success in Selling a Business to Your Children

If you want to keep your business in the family, you can sell the company to your children. The sales proceeds will provide you with retirement funds. Under current tax law, your profit on the sale will be taxed at only 15 percent, as a long-term capital gain. In 2008-2010, the rate gets even better for certain taxpayers. (See **Note** in right-hand box.)

Among the options, you can sell part or all of the company to your children (or other successors within the family) on an installment or "Earnout" basis.

The advantages of this approach:

- The payments will be made over a period of years.
- Terms can be worked out so the payments are manageable for the children.
- Interest must be charged on the deferred payments, based on rates published monthly by the IRS. However, today's relatively low interest rates make it easier for the buyers to handle the debt they incur.

An installment sale permits the deferral of capital gains tax over the life of the arrangement. Meanwhile, the sale removes not only the shares but any future appreciation from your estate.

### Better Deal

In order to receive capital gains treatment when you sell your company, you generally have to break off all of your activities relating to the business. Otherwise, the proceeds you receive can be considered a dividend, taxed as ordinary income.

Years ago, that was a tax trap. Under current tax law, however, such a dividend is likely eligible for a 15 percent tax rate, the same as the capital gains rate.

Therefore, it is possible to sell your company and continue to serve as a board member or in another position, without paying a tax penalty. This area of the tax law can be complex so it is important to work closely with your tax adviser.

An installment sale can still pose a problem, though. If you die before all installment payments are made, the value of the unpaid installments will be included in your taxable estate.

To address this concern, you might sell the shares to your children and take back a self-canceling installment note (SCIN). If you die before all of the installment payments are made, the rest of the payments will be canceled and the remaining portion of the SCIN won't be included in your estate.

To obtain this possible tax break, your children must make negotiating concessions. With a SCIN, the children have their payment obligation capped yet they have the opportunity of ending the payments early if you die prematurely.

**Note:** Under current law, qualified taxpayers in the regular 10 percent and 15 percent income tax brackets pay zero percent long-term capital gains tax in 2008 through 2010.

However, certain children under age 19 and full-time students under age 24 will not qualify for the zero percent rate under recently revised Kiddie Tax rules. Taxpayers in higher tax brackets currently pay 15 percent on long-term capital gains.

If you die before receiving all the installment payments, your family will get an estate tax break but your estate might have to recognize the remaining capital gain. Still, your family will come out ahead paying capital gains tax, now 15 percent or less, rather than estate tax, where rates can be as high as 45 percent.

***Another tactic:*** Have the company buy shares from you, thus increasing the stakes of other shareholders. In tax language, this is called a partial redemption. The payment you receive from the company in exchange for the redeemed shares will generally be a qualified dividend that is taxed at no more than 15 percent (plus the state income tax, if any). Depending on some complicated rules that we don't have to go into here, part of the redemption payment may simply reduce the basis of your shares, which creates totally tax-free treatment for that part.

The bottom line is you pay no more than 15 percent to the U.S. Treasury. If the other co-owners also participate in the redemption transaction in proportion to their respective stock ownership percentages, your ownership percentage will remain the same. However, if you sell your shares and your children hold onto theirs, their respective share of ownership increases.

Again, you must relinquish all interests in the company for capital gain treatment. However, a partial redemption that results in dividend treatment will not raise your tax bill, under the 2003 tax law. Redemption plans work best when the company has a large amount of cash that is not needed for operations.

In some situations, you might want to use a combination plan. Let's say you own 80 percent of your company, as described above. That 80 percent interest is valued at \$2 million, and your company has an excess \$500,000 in cash. This cash can be used to redeem 25 percent of your shares (20 percent of the company) while the remainder can be sold to your son, using an installment sale or a SCIN.

These are just some of the options available. Consult with your tax adviser for the best succession choice for your family and business.