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White Paper

Structuring a Tax-Free Sale

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Structuring a Tax-Free Sale

What is a tax-free sale?

You want to sell the business that you have owned for years. It has appreciated significantly in value, but you want to retire or move on to something else. If you simply sell the business for cash, you will realize a significant taxable gain. However, if you want to avoid paying capital gains tax now, you can opt for what is known as a tax-free sale or tax-free reorganization of your business. Under certain conditions, as set forth in Section 368 (a) (1) of the Internal Revenue Code, you can structure a tax-free sale of your business. In such a transaction, you exchange your business's stock or assets tax-free for the voting stock of an acquiring corporation.

Technical Note: A variation on the tax-free sale is the statutory merger, whereby two or more corporations merge under state corporate law to form a single corporation, and one of the original corporations ceases to exist. Such a merger may also qualify as a tax-free transaction under Section 368 (a) (1) of the Internal Revenue Code. In many cases, the seller in a tax-free sale is a small or closely held business, while the buyer is a large, publicly held corporation. Structuring a tax-free sale may make sense if you own a viable small business and want to sell it without immediate tax consequences. However, because this kind of transaction must meet complex Internal Revenue Service (IRS) rules and requirements, you should consult additional resources including your tax advisor and/or attorney. There are three basic types of tax-free sales:

Tax-free stock sale

Tax-free stock sales, known as "B" reorganizations, occur when the selling corporation trades its shares of stock for voting stock in the purchasing corporation. Although you don't have to exchange all shares of your company's stock, the Internal Revenue Code requires that you sell at least 80 percent of your corporation's shares of voting stock and at least 80 percent of the total number of shares of other classes of stock. In exchange, you must receive only shares of voting stock from the acquiring corporation. If you receive shares of any other class of stock, the transaction will not be eligible for tax-free status.

Tax-free asset sale

Tax-free asset sales, known as "C" reorganizations, occur when the selling corporation exchanges its assets or properties for voting stock in the acquiring corporation. For this type of transaction, the IRS requires the sale of substantially all of the selling corporation's assets to the acquiring corporation. Although the IRS does not explicitly state how much of the selling corporation's assets should be sold, you should retain only those assets needed to meet your business's pre-existing liabilities. Generally, a "C" reorganization will satisfy IRS regulations if your business transfers assets to the acquiring

corporation with a value equal to at least 90 percent of the fair market value (FMV) of net assets (gross assets less liabilities) and at least 70 percent of the FMV of the gross assets. After a tax-free asset sale, the selling corporation must be liquidated, if you and the other shareholders of the selling corporation desire to hold the stock of the acquiring corporation directly.

An asset sale may still qualify for tax-free treatment if some of the shares of stock of the acquiring corporation are not voting shares. However, at least 80 percent of the FMV of the shares of the acquiring corporation received in an asset sale must be voting shares for tax-free treatment to be preserved.

Statutory merger

A statutory merger, known as an "A" reorganization, occurs when one corporation is merged under state corporate law into a surviving corporation with the shareholders of the merging corporation converting their shares of the merging corporation's stock into shares of stock of the surviving corporation, or the surviving corporation's parent. The shareholders of the merging corporation may receive assets other than surviving corporation stock in an "A" reorganization (including cash). However, to the extent that cash and other assets are received by the merging corporation's shareholders, the shareholders will have to recognize gain in the transaction.

When can it be used?

A tax-free sale may be an option when you want to sell your business while avoiding or at least postponing payment of capital gains tax. A tax-free sale will only be possible if your business is organized as a corporation.

Strengths

You defer your capital gains tax

Assuming the sale qualifies for tax-free treatment, you and/or your business won't have to pay capital gains tax as a result of the transaction. You will only pay the capital gains tax if you subsequently sell and realize a gain on the shares received from the acquiring corporation.

Public stock is a relatively liquid asset

Although a tax-free sale does not provide you with instant cash, you can sell the stock received from the acquiring corporation with relative ease (if it is publicly traded) in the event that you need cash for an emergency.

Caution: Keep in mind that publicly traded stock is much more liquid than stock in a nonpublic corporation. This may be a crucial point to consider as you plan for a tax-free sale of your business.

Heirs can receive stepped-up basis

This can be an important consideration in terms of planning for the future of your children or other heirs. If you hold on to the stock received from the acquiring corporation until your death, you defer your capital gains indefinitely, and your heirs can receive a stepped-up tax basis. If you sold these shares before your death, your tax basis would be based upon your initial investment in your own business. The people who inherit these same shares will have a tax basis equal to the shares' value at the time of your death. If your heirs decide to sell the shares in the future, this stepped-up basis will result in a lower capital gains tax liability.

Caution: If the value of your estate exceeds the applicable exclusion amount (formerly known as the unified credit), then holding on to the shares until your death could trigger estate taxes in excess of the capital gains tax that would result from selling the shares during your lifetime. If so, it might be better to sell the stock, pay the capital gains tax, and then transfer the proceeds to your beneficiaries during your lifetime to avoid estate taxes.

Caution: In 2010, when the estate tax will be repealed, assets transferred at death will not receive a step-up in basis but will receive a carryover basis instead.

Tradeoffs

A tax-free sale is a complicated transaction

The complexity of structuring a tax-free sale will require that you enlist the aid of an attorney and/or tax advisor.

It can be difficult to find a buyer

One obstacle to planning a tax-free sale can be that it is often difficult to find an appropriate acquiring corporation willing to pay you the FMV of your business in the form of voting stock.

There will be a waiting period before you can sell stock

While the stock received from the acquiring corporation can be sold fairly easily if the stock is publicly traded, it is still not as liquid as cash. Moreover, federal securities regulations will require you to hold the stock for a period of up to two years before you can resell it, during which time the stock may decrease in value.

There may be estate tax consequences

If you hold on to the stock until your death, there may be serious estate tax consequences. Specifically, while holding the stock will allow you to defer your capital gain and provide your beneficiaries with a stepped-up tax basis, keep in mind that upon your death, the stock will become part of your estate and

be subject to federal estate taxes (except in 2010) if the value of your estate exceeds the applicable exclusion amount.

How to do it

Hire an attorney and/or tax advisor to assist you with setting up the transaction. Establish the FMV of your business and find a corporation willing to exchange shares of their voting stock for the stock or assets of your business. Finally, determine if a tax-free stock sale, a tax-free asset sale, or a statutory merger would be more appropriate in your case.

Tax considerations

Capital gains tax

Assuming the sale qualifies for tax-free treatment, a tax-free sale will enable you and/or your business to defer the capital gains tax triggered by the sale. You will only pay the capital gains tax if you subsequently sell and realize a gain on the shares received from the acquiring corporation or if you receive any consideration from the acquiring corporation other than the acquiring corporation stock in the transaction.

Stepped-up basis

Rather than sell the shares during your lifetime, you can hold on to them until your death. Exercising this option will not only further defer your capital gain but may also give your beneficiaries a step-up in their tax basis, except in 2010. If the beneficiaries then sell the shares after your death, their capital gains tax may be significantly less than the capital gains tax you would have paid if you had sold the same shares during your lifetime.

Example(s): Your initial investment in your business was \$50,000. Years later, you structure a tax-free sale of your business and receive shares of voting stock in an acquiring corporation. A year later, you sell the stock received for \$100,000. When you subtract your cost basis (the original \$50,000 investment) from the \$100,000 for which you sold the stock, you get a capital gain of \$50,000.

You hold on to the shares received from the acquiring corporation until your death so that your daughter may inherit them. If the shares' value at the time of your death was \$120,000, then your daughter's cost basis will also be \$120,000. Your daughter needs to sell the shares two months later to raise money for her college tuition. Even if the shares' value rises over the two-month period to \$150,000, she can sell the shares for the \$150,000 and end up with a capital gain of only \$30,000 (\$150,000 less her cost basis of \$120,000). In effect, the stepped-up basis allows her to realize a taxable gain of \$20,000 less than you would have realized even though the shares' value has risen.

Gift and estate tax considerations

Holding on to the shares until your death will cause them to become part of your estate. If the value of the shares plus the other assets in your estate exceeds the applicable exclusion amount, the estate will be subject to federal estate taxes, assuming your death is not in 2010. Depending on the anticipated value of your estate, it may or may not be a good idea to hold on to the shares until your death. It may be a better idea to sell the shares during your lifetime, pay the capital gains tax, and then transfer the proceeds to your beneficiaries before you die to minimize estate taxes.

There may be other estate tax planning issues, particularly for married couples.

Disclosures

This material does not constitute the rendering of investment, legal, tax or insurance advice or services. It is intended for informational use only and is not a substitute for investment, legal, tax, and insurance advice.

State, national and international laws vary, as do individual circumstances; so always consult a qualified investment advisor, attorney, CPA, or insurance agent on all investment, legal, tax, or insurance matters.

The effectiveness of any of the strategies described will depend on your individual situation and on a number of other factors. After reviewing your personal situation, we may recommend that you not use any strategy in this document but instead consider various other strategies available through our practice.

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