Plan for Income and Capital Gains Tax

Business Owner Action Item: Engage Hibiscus Legal to (i) evaluate the income and capital gains tax liability, and (ii) reduce the income and capital gains tax liability.

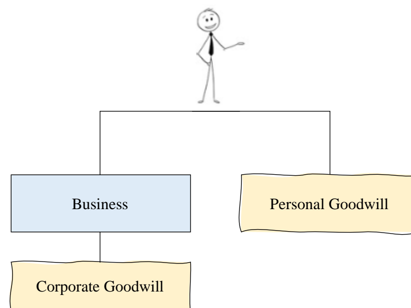
Why is This Important? The income and capital gains tax are the largest tax liabilities a business owner will incur when selling the Company.

Strategy 1: Qualified Small Business Stock

- Gains from the sale of Qualified Small Business Stock ("QSBS") is eligible for up to 100% exclusion from federal income tax up to $10 million.
- Basic Requirements
    - ***C corporation***: The stock must be stock in a business entity taxed as a C corporation for income tax purposes.
    - ***Original Issuance***: The business owner must acquire the stock at "original issuance in exchange for a capital contribution or services.
    - ***Five-year hold***: A taxpayer must hold QSBS for at least five years.
    - ***Qualified small business***: The C corporation must be a "qualified small business" under section 1202 during substantially all of the taxpayer's QSBS holding period.
        - Gross assets of less than $50 million from incorporation to the issuance of the business owner's stock.
        - At least 80% of the corporation's assets are used in the active conduct of a qualified trade or business.

Strategy 2: Identify Personal Goodwill

- This strategy allocates part of the purchase price in an asset sale to personal goodwill, which is taxed at long-term capital gain rates.
- When the assets of the Company are sold via an asset purchase agreement, part of the purchase price will be allocated to goodwill.
- There are two kinds of goodwill: corporate goodwill and personal goodwill. Corporate goodwill is an intangible asset owned by the Company. Personal goodwill is an intangible asset owned by the business owner.
- Personal goodwill is taxed at long-term capital gain rates.
- Corporate goodwill is taxed at ordinary income rates.
- The business owner should allocate as much of the purchase price to personal goodwill as possible.



Strategy 3: Private Equity Transaction

- The purpose of a private equity transaction is to defer recognition of capital gains tax from the sale of the Company.
- A private equity transaction has three unrelated parties: the business owner, a trust or limited liability company (referred to as the intermediary), and the second purchaser.
- The first step is the business owner sells the Company to the intermediary in exchange for a promissory note.
- The second step is the intermediary sells the Company to the second purchaser in exchange for cash.
- The intermediary invests the cash proceeds from the sale to the second purchaser and makes periodic principal and interest payments to the business owner under the installment note.
- The business owner will recognize capital gains on his tax return as installment payments are received, which effectively defers payment of the capital gains tax over the term of the promissory note.
- The intermediary is able to invest the cash proceeds on a pre-tax basis, which increases its return on investments.
- The business owner is required to recognize income in the year interest income is received.