Legacy by Design, LLC

Funding the Transfer

Succession Planning

Farmers, Ranchers, & Family Business Owners

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Kevin Spafford, CERTIFIED FINANCIAL PLANNER™, helps farmers, ranchers, and family business owners plan for succession. Kevin's planning process is designed to enhance the family's financial security, create a smooth ownership transition, and mitigate the tax consequences.

As the architect of the *Farm Journal Legacy Project*, Kevin effected consumer behavior and improved the way family business owners engage in the succession planning process. Through the *Project*, Kevin has:

- Published more than 300 columns in Agriculture's leading magazines.
- Facilitated workshops for thousands of farm and ranch families across the U.S.
- Written multiple workbooks and created several client planning tools.
- Produced weekly eNewsletters for subscribers across the country.
- And, hosted 5 seasons of '*Leave a Legacy*' TV.

Prior to the publication of his book *Legacy by Design: Succession Planning for Agribusiness Owners* (Marketplace Books®) in 2006, Kevin founded Legacy by Design, a succession and financial planning firm dedicated exclusively to serving the succession planning needs of farmers, ranchers, and agribusiness owners.

Among a series of professional designations and licenses, Kevin is a CERTIFIED FINANCIAL PLANNER™ and he's earned a Bachelor of Science in Agricultural Management with a concentration in Business, from California Polytechnic State University, San Luis Obispo, CA.

On a personal note, Kevin enjoys flying, fishing, hunting, and camping. He and his wife, Anne-Marie, have been married 37 years. They are proud parents of their son Drew and his wife Dana, and their daughter Sara and her husband Michael. In July of 2018 they welcomed their first grandchild. They live in Durham CA.

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Succession Planning for Agribusiness Owners

FUNDING THE TRANSFER

Many owners (or their families, in the case of a transfer at the owner's death) demand some consideration in exchange for transferring ownership in their business. This may consist of sales proceeds, payments to the owner from the business (e.g., deferred compensation or consulting payments), or both.

Unless the owner is willing and able to transfer his or her business interest as a gift, the succession plan must determine how the successor will fund the acquisition of the owner's interest. Since the proceeds of the sale are often the source of the owner's retirement income, the plan must take into account the owner's retirement needs. These must be balanced, however, by economic reality, that is, how much the business is worth.

Seller financing, insurance, and payments to the former owner by the business are probably the most common sources of funds, especially in smaller transactions between family members. However, obtaining commercial loans and equity financing (i.e., selling an interest in the business to an outsider) are also important funding sources.

Most commercial lenders will not finance 100% of the purchase price of a business. Likewise, the successor's funds are often limited. Therefore, life insurance is a very common way to create the necessary funding. [Clearly, life insurance is more useful for funding a transfer at the owner's death. However, even lifetime transfers can be funded by borrowing against a policy's cash surrender value (CSV). Typically, these funds are repaid from the insurance proceeds at the insured's death.] When the successor's funds, third-party loans, and available insurance are not enough, seller-financing and payments from the business are usually used to plug the gap between required and available funds.

The funding aspect of the succession plan involves quantifying the owner's needs, identifying alternate sources of funds, and determining which are economically feasible, both to the seller and buyer. Both tax and nontax considerations affect the analysis.

USING BUSINESS ASSETS TO FUND THE TRANSFER

Techniques for Funding a Transfer with Business Assets

One of the biggest obstacles to transferring ownership in a business is the ownership successor's lack of funds. This can especially be a problem when the successor is the owner's child whose available cash and credit are limited. Although the owner can (and often does) finance a portion of the sale, many owners try to minimize the amount they finance. Therefore, funds from the business itself are often an important source of financing a transfer.

Reducing the Business's Value before the Transfer Probably the simplest way to use business assets as a funding source is to distribute assets from the company to the owner before the transfer. This reduces the value of the business and thus the funds needed by the successor.

Establishing a liability from the business to the owner before a sale or redemption reduces the company's value, and thus the sales or redemption proceeds that the owner will receive. Although the owner receives less sales consideration, he also has the right to collect the receivable from the company after ownership is transferred. If the payments made to extinguish the liability are tax-deductible, the successor's after-tax cost of the acquisition cost may be even less, since the business will realize a tax benefit. Deferred compensation arrangements are a common method of reducing the company's value with tax-deductible payments.

Establishing a liability to the owner reduces the value of the business without draining assets, since the liability can be paid over a period of time. The taxpayer's accounting method for tax purposes has no effect on whether or not a liability exists. Rather, there must be a real economic reduction in the business's value due to a future obligation to make payments.

By deferring receipt of payment, the owner is usually able to defer the related tax. However, the owner often is an unsecured creditor, meaning that he must rely on the successor's ability to generate business cash flow to be paid.

Reducing the business's value can be especially important if the business is transferred to a family member. It is not unusual for the owner to set a lower price for family members than what would be asked if the buyer were unrelated. The IRS often scrutinizes transactions between related parties, to determine whether the sales price was less than the FMV of the property sold. If this attack is successful, the amount by which the FMV exceeds the sales price may be deemed to be a gift from the owner to the purchaser. Reducing the business's value before the sale reduces the chance that a gift could be asserted.

Agreeing to Making Future Payments Another way to use business assets to fund the ownership transfer is for the business to contractually agree to make future payments to the owner. Common examples are consulting arrangements, covenants not to compete, and rental or royalty agreements. These payments are also generally tax-deductible, and thus, reduce the purchaser's after-tax cost.

It is very important to ensure that the payments are reasonable relative to the services or assets provided to the business. Payments in excess of value could be recast as additional (nondeductible) sales proceeds.

To summarize, the ownership successor receives a tax benefit when the business makes deductible payments to fund the ownership transfer. Payments that can be accrued before the ownership transfer have the additional benefit of reducing the value of the business, which reduces the sales or redemption proceeds due to the owner. This can be especially useful in a transfer to family members when the owner wants to transfer the business at the lowest possible value. Reducing the business's value before it is transferred also reduces the gift tax value and, thus, helps owners gift a greater percentage of the business without incurring gift tax.

The various payments that can be used to fund an ownership transfer have unique tax and economic consequences to the owner, the ownership successor, and the business. These must be considered when evaluating business payments as a funding source. The following paragraphs describe several available options.

Nonqualified Deferred Compensation Plans

A nonqualified deferred compensation plan is a tax-efficient way to facilitate a future sale of the business. As the liability for the owner's deferred compensation increases, the value of the business decreases, reducing both the gift tax value and the selling price.

Establishing the deferred compensation plan results in less sales or redemption proceeds to the owner at the transfer. However, the owner will receive the balance under the deferred compensation arrangement in future years. Deferring owner compensation usually defers the related tax liability. However, it also puts the seller at risk of nonpayment if the business fails.

Receiving deferred compensation instead of sales proceeds often results in additional tax for the owner, since capital gain may be traded for ordinary income. This is the case when stock is sold if the sale results in long-term capital gain. Substituting deferred compensation for sales proceeds reduces capital gain that would be recognized on the stock sale. When assets are sold, the effect of increasing deferred compensation (ordinary income) and reducing sales proceeds depends on the nature of the assets sold. To the extent the asset sale generates ordinary income, reducing the sales proceeds and increasing deferred compensation does not result in some of the owner's payments being taxed at a higher rate. The same holds true for the sale of a partnership interest, since a gain on such a sale may be capital or ordinary (or both) depending on the amount of hot assets the partnership owns. To the extent selling the partnership interest would result in ordinary income, there is no disadvantage to the owner to receiving deferred compensation instead of sales proceeds. In any case, deferred compensation is subject to FICA and FUTA tax, while sales proceeds are not.

If the purchaser is a family member, the owner may view paying a greater share of the tax on the sale as a way of transferring wealth to the successor (whose tax liability is reduced by using the deferred compensation as funding) without incurring gift tax. If the successor is not a family member, the additional tax borne by the owner becomes a negotiating point. The owner is compensated either by a purchase price adjustment or some other concession in negotiating the transfer.

Observation: Establishing a deferred compensation arrangement for the owner has similar economic results for the owner as seller financing. In both situations, some payments (and the related income tax) are deferred until after the sale. Also, in both cases, the seller's payments usually depend on the business's future success. However, an installment sale may result in less ordinary income and thus, less tax. For the buyer, the deferred compensation arrangement results in a lower tax liability than an installment sale, since the entire deferred compensation payment is deductible, rather than only the interest on an installment note.

A deferred compensation arrangement would be appropriate when the seller is comfortable that the successor will make the deferred compensation payments. If assets, rather than the business entity are sold, competent counsel should be retained to ensure that the contractual obligation to pay the deferred compensation is transferred to the purchaser.

Establishing a deferred compensation arrangement can be a tax-efficient way to fund a future transfer of the business. However, each year's total compensation (both actually paid and deferred) must be reasonable based on the services provided. Therefore, it can take several years to build a deferred compensation account large enough to provide significant funding. This is an excellent example of the importance of starting business succession planning early. An owner who would like to transfer the business in the next few years generally would not be able to build a very large deferred compensation amount.

Compensation for Past Services

In some cases, the value of the business can be reduced by paying compensation for past services performed by the owner. This has a similar effect as establishing a deferred compensation account because the value of the business in reduced by the payment.

The key to this technique is whether the bonus is reasonable. A business can deduct compensation payments for previously under-compensated years. Thus, the business must be able to demonstrate that compensation paid in prior years was less than the value of the services performed. Often, the reason for paying less than fair value was that the company was underfunded at the time or all cash was being reinvested in the business.

To substantiate the amount of the bonus, the corporate minutes for that year should reflect that the additional amounts are to compensate the owner for previous underpayments of compensation. Ideally, the minutes for the previous years (in which the owner was under-compensated) should reflect the amount that was paid, what the services were actually worth, and the reason for paying less than FMV. Of course that is only possible if the owner had started planning early. As a practical matter, the bonus for past services may be an option used by owners who have not planned, but who can substantiate previous underpayments of compensation.

Consulting and Employment Agreements

Consulting and employment agreements can supplement the owner's income after retirement if the owner wants to stay active in the business and the company can benefit from his or her services. A consulting or employment arrangement should be supported with an official contract, signed by both parties, and should provide for specific duties to be performed by the former owner. For instance, the new owners may need the owner's services to network with industry contacts, maintain relationships with customers and suppliers, and supplement operational knowledge of the company. Consulting fees or employment wages paid to a retired owner are deductible as compensation expense by the company and ordinary income to the recipient.

The amount paid for services by the retired owner must be reasonable in relation to the work performed. Otherwise, the IRS may classify payments to the former owner as dividends or additional sales proceeds. The reasonableness test is one of facts and circumstances, however, the compensation paid to the former owner should be supportable by what would be paid for similar services in an arm's length transaction.

An employment agreement is generally a contract for full-time services and provides for a continuation of salary and benefits, whereas a consulting agreement is generally on a part-time or "as needed" basis and usually does not provide for a continuation of salary and benefits. The owner will normally be paid a periodic retainer or on an hourly basis as services are performed.

Royalties, Licensing Fees, Brokerage Commissions

Another strategy to provide cash flow to the retiring owner is through the payment of royalties, license fees, or brokerage commissions. Royalties can be paid to the owner on products created by him and distributed by the company. If the business has proprietary licensing agreements that require the former owner's involvement, license fees can be paid in consideration for the owner's efforts to maintain those agreements. If a retiring owner has contacts and expertise in negotiating contracts for the purchase of goods and materials, commissions can be paid in exchange for his brokerage services. Royalties, licensing fees, and commissions are deductible business expenses to the company and ordinary income to the recipient.

Lease and Purchase Options

Operating equipment or real estate held outside the business entity may offer planning opportunities if the retiring owner can lease these assets back to the business. Leasing arrangements can provide an additional source of income to the former owner. In addition, purchase options can be paid by the company to the retired owner to "lock in" a current price for the assets or simply to lock in the option to buy the property in the future. When the option is exercised in the future, the asset is sold to the business, generating additional income to the former owner.

Covenants Not to Compete

If the owner is selling his business to an unrelated party, or a commercial lender is involved in financing the succession (e.g., a leveraged buy out), a noncompete covenant may be required of the retiring owner.

A noncompete covenant which meets the IRS tests for reasonableness is a method of compensating the retiring owner for assurances that he will not compete with the business in the future.

Unlike consulting fees, noncompete payments are not subject to self-employment tax. However, in order to be considered a deductible business expense (and not a disguised part of the sale price of the business) the IRS requires certain tests be met. In general, the covenant should have a value that can be supported by an outside opinion or appraisal and some independent basis or relationship with existing business conditions.

Assigning Value to the Covenant If the buyer acquires assets that make up a trade or business, allocating costs to a covenant not to compete is not very attractive. Most buyers would prefer to allocate their costs to assets that will be recovered in less than 15 years (e.g., receivables, inventory, machinery, and equipment). Buyers benefit from faster recovery of their purchase price while sellers may end up with more capital or Section 1231 gain on an asset sale, rather than ordinary income from the covenant. If the IRS discovers that a covenant has been entered into under such circumstances, the auditor may attempt to shift the allocation of purchase price away from other assets and towards the covenant.

Payments to former owners for covenants can usually be supported only when the former owner has the actual capacity to compete (in terms of geographic location, age and health, financial resources, business contacts, ability to enter the market without restriction, etc.). Even then, one of the following circumstances normally must also apply:

- A service or knowledge-based business is acquired, as opposed to capital-intensive businesses.
- The former owner possesses special technical knowledge (such as information about formulas or secret processes).
- The former owner has significant marketing abilities.
- The former owner has an outstanding reputation with a resulting group of loyal customers.

USING SELLER FINANCING

Seller financing is common when a business is sold. Banks will normally finance only a percentage of the hard assets and none of the goodwill (the amount of the purchase price in excess of the underlying assets' value). Thus, sellers often must fill in the financing gap left by the bank. Seller financing can also help the seller negotiate a higher selling price, especially if he or she is willing to charge a lower interest rate on the note than would be charged by a bank. Seller financing has the advantage of being fast and convenient, since there is no approval process, and inexpensive, since there are no loan fees.

Ensuring Repayment

Obviously, the seller is concerned about the tax consequences of seller financing. However, the seller's primary concern is usually the risk of default associated with the buyer's purchase obligation. (Simply put, the seller wants to get paid.) The seller's concerns about the buyer's ability to pay are well-founded if business cash flows are the buyer's main source of funds for debt repayment. This concern may be heightened if the seller has no continuing role in the business operations. Since the seller's future financial security may depend on the buyer's ability to successfully run the business, the business owner must be careful to objectively evaluate the buyer's ability.

Obtaining and carefully evaluating the buyer's business plan detailing how the debt will be repaid is a very important means for evaluating the buyer's ability to repay the debt. Of course, the seller should take all other common business precautions, such as obtaining a lien on assets, personal guarantees from the buyers, life insurance on the remaining owners (e.g., policy assignment or purchase), and a pledge of the company's stock or partnership or LLC interest as collateral on the installment note. (If an ownership interest is accepted as collateral, the seller should be aware that an interest in a business unable to make installment payments may not be worth much.) The seller should also restrict the borrower's ability to strip cash out of the business by setting compensation caps and limiting the buyer's ability to borrow additional funds. However, if a commercial lender is also financing part of the acquisition price, the seller will probably not receive the same level of security as the commercial lender.

Setting the Terms of the Debt

Typically, the seller receives a down payment and the buyer's note for the balance of his portion of the financing. The note usually obligates the buyer to make regular interest and principal payments for a specified term. At the end of the term, the buyer may make a balloon payment for the remaining note balance.

To avoid the imputed interest rules, the note must require an interest rate at least equal to the applicable federal rate (AFR) in effect at the time of the sale. Also, in a related party sale, an interest rate materially higher than the amount that would be charged an unrelated party of the same creditworthiness could be viewed by the IRS as a gift from the buyer to the lender (thus reducing the buyer's basis), but that is rarely the case in the typical succession scenario.

Choosing an interest rate may affect the amount of ordinary income (vs. capital gain) that that seller will realize. Generally, a higher purchase price can be negotiated if the interest rate is lowered. This tends to decrease the seller's ordinary (interest) income and increase his or her gain on the sale of the business. Conversely, the buyer's tax situation is often improved if a lower purchase price is exchanged for a higher interest rate, since the interest expense is deductible currently, while the purchase price is capitalized.

Another negotiable point is the amount of the down payment. Obviously, the greater the down payment, the less risk the seller assumes in the form of a note receivable. However, the down payment may be limited to the buyer's available cash.

In a sale to a family member, the purchase price and interest rate may not be negotiated strictly based on the buyer's and seller's opposing interests. Instead, the seller may determine the amount of income required for retirement (taking into account the down payment and any other assets owned). If the seller is financially able, he or she may help the buyer by charging a lower rate of interest than would be required from an unrelated party. However, the interest rate must at least equal the AFR to avoid recharacterizing some of the principal payments as interest income to the seller.

The fact that the purchaser is a family member should not cause the seller to ignore basic business practices. In fact, every aspect of the loan should be as business-like and well-documented as if the purchaser were an unrelated party. Undocumented loans between related parties are susceptible to being treated as gifts by the IRS. Also, future misunderstandings that could harm family relationships may be avoided if all parties understand and agree to written terms of the loan in advance.

Avoiding Imputed Interest

When adequate interest is not charged on a sale in which the seller receives some payments after the sale date, the IRS will recharacterize a portion of the purchase price as interest income. Thus, the seller must report a portion of the total purchase price as interest income, which often has the effect of transforming capital gain into ordinary income. If interest is recharacterized under these rules, the buyer reduces his or her purchase price (i.e., basis) by the imputed interest.

Interest is adequate for these rules if it at least equals the applicable federal rate (AFR), which is based on current Treasury bond yields and is published each month by the IRS. Usually, the appropriate AFR is the lowest AFR in effect during the three-month period ending with the first month in which there is a binding contract for the sale or exchange, or, if no contract exists, the month the sale occurs. However, special rules apply to sale-leasebacks between related parties and certain short-term (i.e., one year or less) obligations.

Two sets of rules potentially apply to sales of nonpublicly traded business interests. These rules apply regardless of whether the seller and buyer are related parties, but are much more likely to affect a sale to a family member, since setting a below-market interest rate is less common in a sale to an unrelated party.

The Section 1274 Rules Under Section 1274, debt instruments are tested to determine if they have original issue discount (OID). If so, the OID generally is recognized (interest income to the seller and interest expense to the buyer) on the accrual method, regardless of the parties' overall accounting methods. This can be very onerous to the seller, who may be taxed on interest income before receiving cash to pay the tax.

Addressing the Buyer's Concerns

Potential At-risk Limitation Seller financing can raise an issue under the at-risk rules that apply to individuals and certain closely held corporations. The buyer is not considered at-risk for debt if the lender is related to any person (other than the purchaser) who has an interest in the business [IRC Sec. 465(b)(3)(A)]. This could present problems if the seller owns less than 100% of the business and is related to one of the other owners. The effect of the IRC Sec. 465 at-risk rules may be to limit the deductibility of losses which the buyer incurs in the course of operating the business.

Nontax Issues In a family sale, the seller may be more willing to provide guidance to help a purchaser operate the business. This may be a source of conflict if the seller stays involved in the business (both professionally and emotionally) more than the new owner would like. This may be especially uncomfortable for the buyer if the seller is a parent who treats the buyer as a young child needing instruction. On the other hand, the seller may need the income from the note receivable for retirement and therefore have a valid reason to remain involved.

When ownership is transferred to a family member, the authors recommend that the ground rules be set before the sale takes place. If the parent feels entitled to a certain amount of authority because he or she has financed the sale, the degree of the authority should be established to both parties' satisfaction. For example, the buyer may agree to consult the parent-seller on certain issues (perhaps transactions exceeding a certain dollar level or any kind of strategic reorganization), while the parent agrees to refrain from dealing with customers or employees directly and to refer all concerns to the child/buyer. Another approach would be to set rules about when the business can and cannot be discussed (e.g., no business discussions at family holiday gatherings) but the parties will agree to meet periodically to discuss business concerns.

Using a Contingent Pay Note to Facilitate a Sale

The buyer's primary concern is usually that the business will not generate sufficient after-tax cash flow to service the acquisition debt and provide a living. One way to reduce the buyer's risk is an earnout deal, which is a sale with a selling price that is contingent on the business's performance. Generally, the seller takes back a note for some or all of the acquisition price, but rather than being fixed, the repayments are tied to the company's earning during the note's term. Thus, if earnings are less than expected, there is a corresponding decrease in the required payment on the note to the seller.

Earnouts may also be attractive if the seller believes the business has a potential upside that has not yet been realized. This may be the case for a seller who has created a new technology, system or process that has the potential to create significant additional earnings.

A seller who agrees to an earnout provision stands to share in the company's growth, but also assumes some risk of the company's failure. Thus, he is still financially tied to the company's performance. The buyer, on the other hand, has shielded himself from of the business's downside risk by trading off some of the upside potential.

The earnout can be structured any way the buyer and seller agree. For example, the payments can be capped so that the seller shares in some growth, but earnings over a certain level are retained by the buyer. Likewise, the seller's downside potential can be limited, so that future payments are reduced if earnings are less than expected, but not below a certain minimum payment.

There are numerous tax rules related to contingent payment sales. The taxability of contingent payment sales depends on the following three different contingent payment sale situations:

1. When a maximum price is determinable.
2. When a maximum price is not determinable, but the time over which contingent payments will be received is determinable.
3. When neither a maximum selling price nor a definite payment term is determinable.

Maximum Selling Price Can Be Determined Generally, if the seller's maximum amount of sales proceeds is fixed by the sales agreement, the seller is taxed as if he or she will receive the maximum selling price stated under the agreement. The seller's gain and gross profit percentage are computed under that assumption and basis is recovered and gain recognized as each payment is received.

The selling price and gross profit percentage are recomputed in any year that an event reduces the maximum amount payable under the contract. If the remaining selling price is less than the seller's unrecovered basis in the installment receivable, the seller can take a bad debt deduction if the installment receivable becomes worthless. However, if the receivable is not worthless, it is unclear when the seller can deduct the amount by which his basis in the receivable exceeds the remaining payments.

Sales with Fixed Payment Period but No Maximum Price If a contingent payment sale calls for payments over a fixed period, but not a stated maximum selling price, the seller's basis in the property sold is allocated in equal annual increments to each tax year for which payments will be made. But, if the sales agreement includes an arithmetic component that is not the same for each payment year (e.g., annual payments that are a declining percentage of the business's profits), basis is allocated to tax years using that component. In any year that the payment is less than the basis allocated to that year, the basis in excess of that year's payment is carried over to the next tax year. A loss cannot be taken until the remaining installment receivable becomes worthless or the final payment year is reached.

Sales with Neither Maximum Selling Price nor Fixed Payment Period If the sales agreement does not specify a maximum selling price or a fixed payment period, the parties must first determine if a sale has actually occurred or whether the payments made by the buyer really represent payments in the nature of royalties or rent. If a sale has occurred, the seller's basis in the property is recovered in 15 equal annual increments starting with the year of the sale. For any year the payment is less than the basis allocated to that year, the excess basis is reallocated equally to the remaining years in the basis recovery period. This process continues until all basis is recovered or until the remaining installment receivable becomes worthless.

If the taxpayer can show that using these rules substantially and inappropriately defers his or her basis recovery, it may be possible to obtain IRS permission to use an alternative basis recovery method.

USING LIFE INSURANCE TO FUND THE TRANSFER

Life insurance is often purchased as part of a business succession plan. Under the right circumstances it can be the most efficient and economical way to fund a purchase at an owner's death. Life insurance that builds cash surrender value (e.g., whole or universal life) can also help fund a sale at the owner's retirement or disability.

When insurance is used to fund the ownership transfer, the policy is typically on the owner's life, since the owner's death generally triggers the sale. For example, an owner who wants to transfer ownership in the business to his children, but who also needs liquidity in his estate to provide for a surviving spouse could purchase life insurance on his life, naming his children as beneficiaries. The children then use the death benefit to purchase the owner's business interest from his estate. If the plan is for the business to purchase the owner's interest (i.e., redeem stock or liquidate a partnership interest), the business generally purchases insurance on the owner's life.

In practice, this simple plan is often expanded to keep the insurance proceeds out of the owner's estate, by using either an irrevocable life insurance trust or an insurance partnership.

Premiums on permanent life insurance are expensive, especially if the insured is older when the policy is acquired. Borrowing against the policy's cash surrender value (CSV) can help finance the premium payments. However the borrowing must be repaid, typically from the death benefit if the loan is outstanding when the insured dies. Thus, owners must be sure that sufficient proceeds, after repaying any policy loans, will be available to fund the owner's interest in the business.

If the cost of insurance is prohibitive, or if any of the business owners are uninsurable, other sources of funds are needed. Unfortunately, all the alternatives have significant drawbacks. Common alternative funding sources include:

Cash Using cash to buy an owner's interest can be very impractical, since it may be difficult to accumulate the required funds before a triggering event occurs. Also, a C corporation that accumulates a large amount of cash in anticipation of a future buyout obligation may be subjected to the accumulated earnings tax. An S corporation with significant cash reserves may have an excess net passive income problem (assuming the cash is invested) which can create a tax or even terminate the S election if the corporation has accumulated earnings and profits.

Borrowing It may be very difficult to borrow enough to meet a buyout obligation triggered by an owner's death because potential lenders may be wary of a loan to a business (or a surviving business owner) that has just lost a key person. Even if a loan is obtained, it may adversely affect the borrower's credit rating and financial ratios. The loan repayments will likely be expensive, because the loan must bear an adequate interest rate to avoid any imputed income. Also, if an individual borrows to fund a purchase, the interest expense is subject to the investment interest expense limitation.

Deferred Payout Like borrowing, a deferred payout can strain the buyer's cash flow for a significant time and adversely affect the ability to borrow additional funds. Also, if the sale is due to the owner's death, the seller may need the cash immediately to pay estate taxes and other estate settlement costs. Finally, if the payout is very long (generally over 15 years) the IRS may argue that the transaction is not really a sale. Payments made by a corporation would then be recast as dividends to the extent of E&P.