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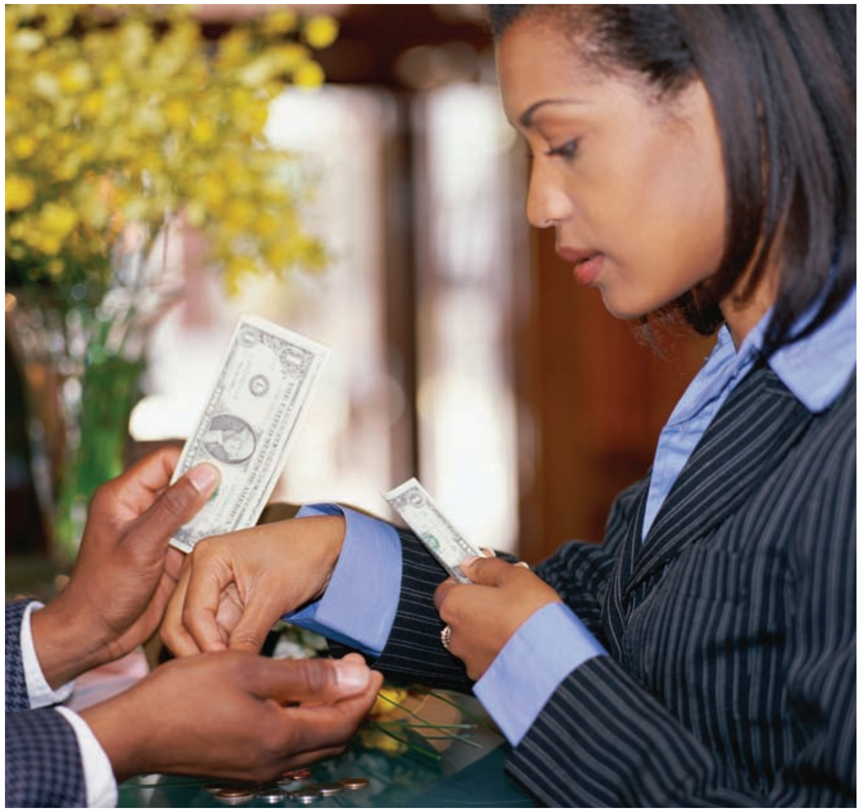
Closing the sale

Financial, estate and income tax planning implications of selling your business



Perhaps you've spent many years building and nurturing a business, and the time to sell has arrived. There are many decisions to make, and indeed time may be at a premium as you negotiate a sale while still running the company. But don't fail to give full consideration to the financial, estate and income tax planning implications and opportunities.

Future financial considerations

Your personal financial goals should determine whether the time is right to sell. But before putting up the "For Sale" sign, you need to mull several questions.

Consider that, once you sell, you'll give up control of the company, the source of your livelihood up to this point. Will you continue to work for the business after the sale? If so, is your future compensation guaranteed? Will the sale proceeds, after taxes, provide an income stream (based on a reasonable rate of return) that will provide financial independence for you and your family? If you're receiving a significant part of the sale proceeds in stock, when can it be liquidated and what are the risks inherent in this new investment? Finally, how do those risks compare with those you've dealt with as a business owner?

Estate planning opportunities

There are estate planning issues to consider as well. Because the real goal of the sale of a closely held business is to maximize value and reduce risk, it presents some interesting estate planning opportunities.

While you still own your business and before you negotiate a deal to sell, stock in the company can be valued with all the uncertainties inherent in the business. The value may indeed be lower than what you hope to get as a sale price. And if you're transferring a minority interest in the business to children or other family members, the value can be discounted because it lacks control and because it isn't readily marketable.

But be careful about taking such valuation discounts and then selling immediately thereafter. For any substantial amount, obtain a formal and independent valuation. The longer the time that elapses between making a gift or other transfer and the sale of the company, the better.

Transfer vehicles

A grantor retained annuity trust (GRAT) can be an ideal vehicle for transferring business interests to family members before a sale. This strategy is designed to transfer excess appreciation to others, while you keep the current value plus a normal rate of return.

If you don't sell the company for as much as you thought you might, you may ultimately transfer little or nothing to the trust. But if all goes well and you sell a year later for an attractive price, the trust will end up with a substantial amount.

For example, let's say your company is worth $3 million today, but a one-third interest is valued with a minority discount at $800,000 and transferred to a GRAT with a two-year term. There is no taxable gift because the trust is required to pay back to you the original value, plus an interest factor based on government tables.

One year later, you sell the company for $3.6 million in cash. The GRAT receives $1.2 million for its one-third interest but will owe around $900,000 to you as grantor (the original $800,000 plus an interest factor for two years). The trust is left with about $300,000 in cash, and none of your lifetime gift tax exemption has been used.

Your personal financial goals should determine whether the time is right to sell.

Minimizing income tax

Your income tax, even at today's low capital gains rates, will be a large number for the year of sale. Do a projection in advance for both the year of sale and the following year. Determine what taxes will be due and what your marginal tax brackets will be in each year. Then look at ways to reduce the tax.

Giving company stock to charity

Rather than selling your company, paying the tax on the capital gain and then making a charitable contribution, consider contributing stock in your company before the sale. This way, you won't pay income tax on part of the gain, and you'll still receive a tax deduction for the fair market value of the contributed stock. It's also possible to transfer stock to a charitable remainder trust, where you'll defer your tax, receive a partial charitable deduction and receive an annual cash flow from the trust.

Start by finding any potential capital losses that can be recognized in the year of sale, when they can be offset against your gains. Then analyze when to pay any state income tax that will be due the following April 15. Beware of both the alternative minimum tax (AMT) and the floor on itemized deductions.

If you'll be receiving consulting fees for a period of years following the business sale, you may be able to establish your own retirement plan based on that self-employment income. Even though a basic retirement plan may allow a contribution equal to 20% of your self-employment income, you can reach a higher amount with a single person 401(k) plan — including catch-up contributions if you're age 50 or over — or with a defined benefit pension plan.

Also, carefully consider how to invest your new wealth in light of your tax situation. Particularly if you have large deductions such as state income taxes and the bulk of your income is long-term capital gains, taxable bonds may be more appropriate for you than lower-yielding tax-exempt bonds, at least temporarily.

Retirement on the horizon

You've spent a lifetime building your successful company, but it's time to enjoy your golden years and retire. Before you do, you have a major task ahead: You must sell your business. Before putting it on the market, consider the financial, estate and income tax implications. ■

Beyond diversification

Why international investing makes sense

Not so long ago, international investing seemed a touch exotic — common among sophisticated investors seeking extra portfolio diversification, but conspicuously absent from too many portfolios.

No longer. As international stocks have steadily outperformed their U.S. counterparts since mid-2002, many investors have jumped on the bandwagon and added non-U.S. stocks and mutual funds to their holdings. Diversification is still an important reason to own non-U.S. stocks — though this benefit isn't as dramatic as it used to be — as is the ability to own shares of some of the world's best companies. But be mindful of the risks.

Diversification and globalization

The oft-cited reason to diversify is to avoid putting all of your eggs in one basket. In other words, when one of your investment types is doing poorly, another may be there to pick up the slack. Global economic changes have somewhat complicated this picture recently.

As globalization increases, domestic companies do more business overseas and international companies find more customers here. For U.S. investors looking to diversify their portfolios, there's good news and bad news.

The good news: Many of the domestic stocks you may own likely already are significantly exposed to international markets through their normal business operations. The bad news: U.S. and foreign stock performance has become far more correlated, and international stocks provide less diversification.

That's hardly a reason to avoid overseas investing. But you may need to rethink your international investing strategy.

Opportunities without borders

In fact, one of the best reasons to invest internationally has little to do with diversification. More than half of the world's market capitalization is located outside U.S. borders. Consider this sampling of household names: cell phone maker Nokia (Finland); consumer electronics giants Sony (Japan) and Samsung (South Korea); energy producer BP (United Kingdom); automakers Toyota Motor (Japan) and DaimlerChrysler (Germany); and food products company Nestlé (Switzerland).

Because many of these and other businesses are widely held by U.S. investors, they won't necessarily provide your portfolio with much diversification. Nor is there any guarantee that stocks with a track record of success will continue to do well. But the lesson is clear: If you ignore international stocks, you may miss out on many companies worth owning.

Funds or stocks?

Mutual funds* can provide a convenient way to invest in a wide variety of foreign stocks.

So-called *international* funds normally invest anywhere in the world, including the United States, while *global* funds typically exclude U.S. companies. The former category can be a useful way to own a cross-section of international stocks, while the latter can be valuable in diversifying a U.S.-heavy portfolio. Bear in mind that international funds may have somewhat higher fees than domestic funds, in part because of the additional research expenses involved with uncovering attractive investment opportunities overseas.

Both international and global funds tend to focus on *developed* markets. However, with their strong performance in recent years, *emerging markets* funds have become increasingly popular with investors. These funds invest largely in developing countries, which, because of their significant growth potential, offer prospects of extremely strong returns.

They also are effective diversifiers because of their limited correlation to more developed markets. But their growth potential comes with significantly higher risks — a good reason why emerging markets should be considered only by investors comfortable with volatility and should never make up more than a small percentage of your portfolio.

If you're the type of investor who prefers owning individual stocks, you can buy shares of foreign companies in one of two ways. The simplest and most common is through American depository receipts (ADRs), certificates issued by U.S. banks that represent shares of a foreign company. ADRs, which trade on U.S. stock exchanges, behave like any other stock and provide a convenient way to invest in many of those businesses — typically, well-known large-cap companies.

An alternative to ADRs is to invest directly in foreign companies through international stockbrokers. This approach provides you the widest variety of purchase opportunities, but also may expose you to additional risk or inconvenience — for example, less transparent financial statements and non-dollar-denominated dividend payments.

Invest for the right reasons

Diversification may be an important benefit of international investing, but owning non-U.S. stocks in your portfolio won't automatically guarantee that you're sufficiently diversified.

Work with your financial advisor to take a holistic view of your portfolio. He or she can help you determine your appropriate mix of domestic and international investments, and take advantage of attractive investment opportunities no matter where in the world they're located. ■

Risks of international investing

When you invest in international companies, keep several unique risks in mind. For example, there's currency risk, which is the risk that the fluctuating relationship between the U.S. dollar and the company's local currency will alter the value of your investment.

Currency movements can work either for or against you. In fact, one of the major reasons international stocks have done so well for U.S. investors in recent years is the dollar's weakness relative to the euro, pound, yen and other world currencies. On the other hand, a rally in the dollar could mean a more challenging environment ahead for investors in foreign companies.

Investing overseas also involves political risk — a broad risk category ranging from regulatory and tax changes to the threat of government upheaval, all of which can adversely affect share prices.

**Mutual funds are sold by prospectus. Investors should carefully read the prospectus before investing. They also should carefully consider information contained in the prospectus, including investment objectives, risks, and charges and expenses, before investing. For this and other information, request a prospectus from your financial professionals.*

Time to cash out?

Selling your home for the right reasons

If you're thinking about selling your home to lock in recent gains, you'll probably agree with *Time* magazine's assessment: "The heady growth of [real estate values in] recent years is clearly over, and prices may soften over the next few years — both good reasons to take something off the table."

But don't rush to call your real estate agent just yet. That passage wasn't from last month's issue, or even from last year — it was from November 2002. If you had followed that advice, you would have missed out on some significant appreciation.

By all measures, most local housing markets appear to be slowing under the weight of higher interest rates and a weaker economy. Should you take advantage of still relatively high real estate prices in many regions by cashing out of your home?

What's your motivation?

Depending on your motivation for selling, there are good reasons why you might. But if you're mostly worried about market conditions and are thinking primarily of your potential financial gains, you should probably think again.

In most cases, your best opportunity to lock in real estate gains comes when you're already thinking about selling your house for other reasons. Perhaps you're an empty nester nearing retirement and considering downsizing, or maybe you're a new parent whose two-bedroom condo is now too small for your growing family.

These can be good reasons to sell your home sooner rather than later, particularly if you live in a market where housing prices may be overvalued and due for a correction. If you're looking to move anyway, the opportunity to make a profit on the sale of your home can be a nice incentive to move quickly.

Proceed with caution

But if you weren't already looking to move, the rationale for selling your home to lock in profits becomes much less compelling. For starters, you'll need to find somewhere else to live. Unless you're planning to move to a less costly market, your new house probably will be comparably priced to your old one.

Another option, of course, is to rent instead of buy, and wait until housing market conditions become more favorable to purchase a new place. This strategy can work well if you can accurately anticipate future housing market trends — something that historically is no easier than trying to predict the direction of the stock market. If home prices recover faster than expected, you may find yourself wishing you hadn't sold.

And don't forget about the sizable transaction costs associated with selling a home. Realtor commissions can amount to up to 6% of your sale price. A $500,000 home, for example, will net a $30,000 commission at 6%. In addition, moving expenses can take a significant bite out of your real estate profit, as can the cost of a new mortgage in a potentially higher interest rate environment.

A guideline, not a given

Obviously, everyone's situation is different, and for every general rule there's someone with an exceptional reason to sell. If you're unsure about the best course of action for your situation, talk to your financial professional or find a knowledgeable real estate agent with no vested interest in your decision. ■

Windfall strategy

Planning for higher income years

Professional athletes and entertainers aren't the only people who have high income years that aren't expected to last forever. They're just the more extreme and visible examples.

If you're just a few years from retirement, you may indeed be in the same boat. Or you may be recognizing large and nonrecurring income from exercising stock options or even from a severance package or a payout from a deferred compensation program. Any number of situations can cause your income and marginal tax bracket to be high for a short period, and then drop to a lower level.

The classic tax planning strategy of deferring income and accelerating deductions takes on a much greater importance if you temporarily find yourself in a high tax bracket.

Deferring income

If you're in the same tax bracket from one year to the next, deferring the tax for one year will save you only the interest cost on the tax. For example, assuming a 5% interest rate and the maximum federal tax rate of 35%, the savings from a one-year tax deferral when tax brackets will be the same is only 1.75%. But if your tax bracket will drop next year from, say, the highest 35% bracket to the 28% bracket, you'll have a permanent savings of 7% on top of the time value of money savings of 1.75%.

If you're in a state with graduated tax rates, your savings may be even greater. Now your motivation to defer tax becomes much stronger. Deferring the recognition of income, when possible, generally is the best way to spread your income so that it falls into lower tax-bracket years.

If you're able to spread the recognition of income, perhaps by deferring some of your salary in the years prior to retirement into a deferred compensation program, consider doing so. But if the financial risks are too high, take the money out now and pay the tax. If your money won't be earning interest during the deferral period, be sure to consider that factor as well.

Accelerating deductions

Accelerating deductions may be easier to accomplish, at least in small amounts. To move deductions forward one year, you can pay such items as real estate taxes or state income taxes by Dec. 31 even though they aren't due until the following spring.

Charitable contributions present the biggest shifting opportunity because you can pay them whenever you like. Most charities are happy to take funds in advance. To achieve a more substantial acceleration of charitable deductions, consider creating a private foundation to which you can contribute a large deductible amount in one or a few years, and then use the fund to pay your contributions for many years to come.

Tax projections important

In any such planning, remember that projecting your taxes accurately is crucial. If you're subject to the alternative minimum tax, your marginal tax bracket may not be as high as you think and your deductions may not all be usable.

In addition, deductions are subject to various limitations that may affect their usage. But the ability to shift tax into lower tax bracket years is a powerful tool that merits consideration. ■

Your source for customized investment and financial planning

CFSE
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Successfully managing personal and family finances means making the right decisions today while considering their implications for the future. At CFSE Wealth Management, our sole focus is our client's best interest, and we customize portfolios and financial plans to fit each individual's set of goals and objectives.

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A Certified Public Accountant (CPA), Personal Financial Specialist (PFS) and Certified Investment Management Consultant (CIMC), Jim is the founding shareholder and President of CFSE Wealth Management, Inc.

Jim is actively involved in local organizations including: Morning Star Charities, Inc. (President), Winter Park Chamber of Commerce, the University of Central Florida Golden Knights Club, Winter Park YMCA (Board of Directors), on the Center for Entrepreneurship at Rollins College (Board of Directors) and is an Inductee in the UCF College of Business Administration Hall of Fame.

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Katie is a member of the Winter Park Community Foundation Advisory Board, the Winter Park Chamber of Commerce and Orlando Chamber of Commerce.

By working with our experienced team of advisors, you will benefit from the independent and objective perspective necessary to make your financial vision a reality.

Please call us today at 407-629-7008 to discuss your needs, or visit www.CFSEonline.com for more information on our services.

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