

## USING SECTION 1031 AS A BUSINESS EXIT STRATEGY

Running a going concern requires that the owner keeps an eye on the business continually and often at the detriment to the individual(s) at the helm. Daily operations can interfere with designing a plan to someday leave it all behind and still pocket a monetary reward on the way into the sunset.

Most often, the owner of a small business is nurturing his largest asset; however, most business owners don't take the time to plan for their eventual exit, thus risking a significant part of their life's work. Most professionals agree, that a business owner should begin the process of exiting their business the day it is opened. This is almost never accomplished because of the fast and furious nature of running a business.

There are 9.2 million business owners in the US, and the average business owner is over 50 years old. According to Price Waterhouse Coopers, there is a 2 out of 3 chance that these business owners will leave their businesses in the next 10 years; yet only 22% of business owners have done any succession planning at all.

There is no substitute for a good plan and understanding the assets that have been amassed is key to designing a profitable sale. There is also no reason for any business owner looking to convert his business assets into cash to not be very well versed in the powerful aspects of Section 1031.

Most businesses will have a combination of real property and personal property such as furniture, fixtures, equipment, customer lists, Websites, goodwill, contract rights and a trade name. For tax purposes, these assets are segregated on the books and records of the business and have to be accounted for separately upon sale.

Allocating the sale price to the various categories can be challenging, however understanding the opportunity to defer recapture of previously taken depreciation (subject to tax at 25%) and capital gains tax (subject to tax at 15%) and state capital gains tax (ranging from 0%-9%) should be paramount in the planning process. Aggregated, the tax can be significant and several strategies are available to defer the taxes completely.

The most important aspect is to understand the goals and objectives of the business owner. While cash is always "king" touching it can lead to unintended tax consequences. If the sale of business assets leads only to cash, the long hard work of achieving equity can be diminished by over 30%. A strategy that utilizes a multi-faceted Section 1031 approach can keep all of the cash intact and tax deferred.

Since the majority of the business assets are often times invested in real estate, a Section 1031 Exchange will produce optimum tax relief. The first step is to engage a Qualified Intermediary (QI) to guide the sale of the property as an Exchange. At closing the net proceeds of the real property will be redirected to the QI for the acquisition of like-kind new or Replacement Property. This can be any kind of real estate and located anywhere in the United States. In addition, it can be more than one piece of property. The value is exchanged, not the quantity, quality or character of the old or Relinquished Property. The Replacement Property options are as varied as stand alone whole interest in real estate, partial interest, Tenancy-In-Common (TIC) interest, Umbrella Partnership Real Estate Investment Trust (UP-REIT), and subsurface real estate in the form of Oil and Gas Leases. A combination of any of these

options will produce a diversified portfolio of income producing property. Remember, since the net tax effect on the business owner could easily approach 30%, this 30% significantly increases buying power of any one, or combination of these strategies. Look at it as a tax-free loan from the government.

Consider the possibility of exchanging a portion of the real estate proceeds into that fabulous house in the mountains. Under Section 1031, the business owner need only to rent the property for 2 years, then he can sell his current residents (and take advantage of Section 121) and convert his rental property into his primary residence, which just happens to be his dream home.

Receiving cash over time is one effective strategy as long as the risk is mitigated. Becoming the lender to the new owner may create more attachments than just monetary ones. However, sale proceeds can be redirected to an annuity company for the receipt of funds over time, guaranteed. This concept is referred to as a "Structured Sale" and it is an attractive alternative to other assets that do not otherwise qualify for exchange treatment. Why should a business owner bet his future on the performance of the new owner of his business? Does he really want a first place position on a business asset, having to take over a failing business should the new owner default? Think about this.

Reinvestment of the assets will produce a steady stream of income, and they can be as passive or active as the soon-to-be retired business owner desires. The benefits are encased in what the cash can acquire and not the cash itself. The selling of a business is typically the largest transaction in the business owner's career, failing to recognize the available tools available, specifically the power of Section 1031, can have devastating effects future quality of life. A key rule of thumb is to always remember to plan the exit from a business, not the equity that took so long to accumulate.