STRUCTURED INSTALLMENT SALES: A Business Sales Option for Income Tax Savings and the Reduction of Risk

By William Rothrock, CSSC

Advising business owners on the sale or purchase of a business represents one of the most impactful services an accountant can provide to clients. A successful business represents a lifetime's work for the seller and a lifetime commitment for the buyer. Structured installment sales assist the buyer and the seller by reducing barriers to consummation in the transfer of a business.

Structured installment sales are subject to the statutory requirements of the installment method detailed in I.R.C. Sec. 453.[1]

HOW STRUCTURED INSTALLMENT SALES WORK

Under I.R.C. Sec. 453, the installment method affords sellers of both closely held businesses and appreciated real estate the ability to defer taxable income, possibly permitting a lower capital gains rate as well as a reduction or avoidance of the tax on net investment income. This article discusses the structured installment sale's impact on the sale and purchase of a business. A business owner shouldn't expose a lifetime of work by placing too great an emphasis on tax savings when both risk aversion and replacement of income need to also be considered. Utilizing a structured installment settlement eliminates the doubt of collection without violating the constructive receipts doctrine. All future periodic payments can be designed by the seller and guaranteed by an A-rated insurance company.

Two additional requirements are a part of the sale process for a successfully consummated structured installment sale. First, the sales proceeds must be paid directly to the insurance company and not to the seller. Second, the sales and purchase agreement must contain annuity language specifying the transfer of the installment obligation to the insurance company; the transfer is referred to as a non-qualified assignment. Both actions parallel those used by insurance carriers for the past forty years when implementing a structured installment settlement for personal injury clients and their attorneys.

BENEFITS FOR THE SELLER

A structured installment sale transaction increases the value of the company, removes the obstacles peculiar to a stock purchase, and creates guaranteed retirement income while preserving and expanding tax benefits. The accelerated recapture of invested capital by the buyer due to accelerated depreciation methods available under the asset sale method increase the net present value of the company. Structured installment sales mitigate the impact of the tax on capital gains and net investment income while producing ordinary income during the period of tax deferral. The creation of retirement income for the business owner is an added benefit of deferral. This benefit is often overlooked until after the sale; however, it creates a cash-flow stream to replace that which was formerly generated by the business. Structured settlements were created for the very purpose of protecting clients from the loss of irreplaceable assets required to sustain their long-term needs by substituting a more dependable debtor, the insurance company, for the buyer.

While the sellers are concerned about obtaining ample proceeds to justify a lifetime's effort, buyers are concerned with the possible risk of paying more than the enterprise's value would justify. Due diligence and careful analysis of the business must justify the risk assumed. A structured installment sale transaction reduces risks for the buyer in two ways. First, a stock sale is often the preferred option of sellers, but it requires a more intensive due diligence by buyers and their advisors because of hidden liabilities. A structured installment sale converts the transaction to an asset sale, which reduces due diligence cost, as only the purchased assets are analyzed. This benefit of reduced due diligence cost lends itself to the second benefit — the risk reduction of a structured installment sale.

Additionally, a step-up in the basis of purchased assets and the creation of deductible goodwill eliminate having a balance sheet of fully depreciated assets. Accelerated depreciation, additional first-year depreciation, and an election to expense depreciable business assets reduce the economic effect of the purchase obligation, increasing the net present value of the company. As a consequence, the business seller can increase the selling price of their company.

A structured installment sale smooths the negotiation process by creating flexibility in counterparty demands. It also opens avenues and sale options typically unavailable or limited due to the assumption of risk by either party. Thus, as a sales tool, structured installment sales benefit both the seller and the buyer in the purchase and sales transaction while improving the negotiated result.

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1 While a structured settlement in the context of a recovery for physical injuries is available, the exclusion provided under I.R.C. §104 means that tax deferral is not a motivating factor. Note that Rev. Rule 79-220 makes income earned under the structured settlement excludable under the same Code section.