ADVANCED PLANNING

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Combining a SERP with a Business Buyout

The conventional purchase of an ownership interest in a business, either by the business itself or by the other owners, is not the most tax efficient approach to buying out a business owner. Assuming that the business will be the ultimate source of the cash flow needed to buy out an owner, the conventional arrangement subjects that cash flow to two levels of taxation. The purchaser, whether the business or the other owners, must pay tax on the earnings that provide the cash flow to finance the buyout. The selling owner must report as capital gain the amount received over his basis on the sale of the business interest. The cause of this double taxation is that the purchase of the business interest is not a deductible expense, no matter who the buyer is.

A nonqualified supplemental executive retirement plan (SERP) payable to a departing business owner is taxed to the recipient as ordinary income but is only subject to one level of taxation because the business is entitled to deduct the payments so long as they represent reasonable compensation. Conventional wisdom contends that a nonqualified retirement benefit is a worse deal for the departing owner because ordinary income rates are much higher than capital gains rates. But from the perspective of the cash flow required to generate a *targeted net sum* that the departing owner *wants to receive*, a nonqualified retirement is a more efficient method.

Assume that an individual is an owner of a C corporation and is nearing retirement. Based on a reasonable value of his interest in the corporation and his financial needs, he would like to net $2 million upon the disposition on his interest. Further assume that his basis in the stock that he owns is $100,000. In order for him to net $2 million, the purchase price of his stock would have to be $2,335,294. Of that, $100,000 would be tax free return of basis and $2,235,294 would be long term capital gain. The tax payable at the 15% capital gains rate would be $335,294 which would net the seller $2 million. In order to finance the purchase price of $2,335,294, the corporation will need gross earnings of $3,538,324 assuming a 34% income tax bracket. On the other hand, if the company paid the owner a nonqualified SERP benefit of $3,076,923, he would net $2 million assuming he is in a 35% income tax bracket. Because the company would be entitled to deduct the SERP benefit (assuming that it's reasonable compensation), the cash flow needed to finance the benefit would be almost $500,000 less than the cash flow needed to finance the purchase of stock.

While the quantitative analysis shows that a SERP is more tax efficient than a purchase of stock, the value of the stock can't reasonably be characterized as zero. Nevertheless, establishing a nonqualified SERP can depress the value of the business by virtue of the liability that it creates. In the situation described above, a substantial cash flow savings can be realized if the

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arrangement is modified to provide half of the targeted net proceeds through the purchase of stock and the other half through a nonqualified retirement benefit. Parties considering this approach should begin the negotiations sooner rather than later. As noted above, the corporation is entitled to a deduction for the nonqualified retirement benefit so long as it represents reasonable compensation. The sooner they have established the plan, the stronger the argument that it represents reasonable compensation.

The parties should also obtain high and low end appraisals of the business. The buyer may choose to pay at the lower end, due to the loss of the current owner's driving of the business, while the business itself may want to reward the owner with a retirement benefit. The selling owner will probably be content as long as his targeted net sum is paid.

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