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Planning an Orderly Exit From Business

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Planning an orderly exit from any business is probably more challenging than developing the initial business plan. In a period of changing times, many farmers must consider whether they want to continue "business as usual." High grain prices combined with low beef prices have placed many producers in a cost-price squeeze. Similar conditions are also occurring with other livestock commodity groups. If a person is considering liquidating the business, there are many factors that must be taken into account. The following are suggestions which should be considered when liquidating part or all of a business.

Deferred Taxes

Deferred taxes on the sale of assets is a major consideration. A study by E.L. LaDue (Cornell University) found that deferred taxes can erode 20 to 40 percent of a business's equity and 20 percent of its assets -- depending upon its age, financial structure, and tax strategies. Given the current tax structure, deferred taxes are the largest hidden liability on all farm and business balance sheets. Computing deferred tax liabilities involves three major steps:

1. Determining the dollar value (basis) of the assets that are subject to taxation;
2. Determining the appropriate tax rates; and
3. Multipling the amount in step one by the rate in step two.

The final value of the asset subject to taxes varies with the type of asset and the tax strategy used. It is important to know that tax laws and methods of calculating tax change with time, and that individual circumstances may require different strategies. However, this example illustrates how deferred taxes affect wealth and equity and shows the value of carefully planned liquidation strategies. The examples used in Worksheets 1 and 2 provides a general format for calculating deferred taxes, assuming no special capital gains tax rate, and a combined federal and state tax rate of 35 percent. The example uses a small beef and crop producer who is considering liquidating his farm business. He has a cow herd, pastures steers and heifers, and grows small grains. He is considering either total or partial liquidation of the business.

Results

In Worksheet 1 the market value of current assets are totaled. Current assets are those assets which can be used to generate income within a year, such as feeder cattle, crop and livestock inventory, cash investment in growing crops, supplies and prepaid expenses such as insurance (total $21,835). The current liabilities that would be incurred, such as account payables, accrued interest and expenses, and rents payable (total $7,050). After these current liabilities are paid, they are deducted from current assets. The difference is taxed at 35 percent, which gives a deferred tax liability on current assets of $5,175. It is important to note that self-employment tax must be paid on the net sale of all current assets. Thus, it can increase the overall tax rate on these items by as much as 15.3 percent.

On Worksheet 2, the raised breeding livestock has no tax basis, because the cost to raise them has been expensed in previous years through Schedule F. Thus, deferred tax is $5,600. The machinery line, if sold, has a remaining tax basis of $20,000, when deducted from the $35,000 market value, it leaves a difference of $15,000 with a deferred tax liability of $5,250. Finally, the largest deferred tax occurs with the sale of real estate, because the original property was purchased at a low price and then the land appreciated in value. The bottom line results indicate that a $61,250 deferred tax would be incurred upon the sale of the real estate.

A summary of our case, shown on Worksheet 3, illustrates that the value of assets is $322,835, and $122,050 for liabilities, for an owner's equity of $200,785. However, when the total deferred tax of $77,275 is considered, 38 percent of the equity is lost because of deferred tax liability. The actual owners equity after the sale of the business is not $200,785, but $123,510, thus limiting what can be used for retirement or reinvested in other opportunities.

The importance of tax planning and liquidation strategies to preserve wealth for the business owner is evident. In this case, it may be advantageous to liquidate the business over a period of years to reduce tax in any given year. If equity and cash flow permit, some producers include gifts to family members or make contributions to tax deferred retirement programs. An accountant, lender, and tax lawyer should always be involved in the liquidation of any business to avoid "tax traps" and to facilitate an orderly procedure in liquidation.

Source of Alternative Employment

A major consideration in an orderly exit from business is to examine alternative employment. First, one must examine the availability of employment, earnings, and general overall stability of employment. In today's economy, two out of three individuals have been employed less than three years in their current jobs. In many rural areas, employment availability is limited, and the cost of driving to an area with more opportunities may be prohibitive. A person must also examine job skills, which may require the use of a job consultant to assess job skills, aptitude, and intent. Earnings are another factor to consider. While many jobs are available, the compensation packages may only be slightly above minimum wage and often do not include fringe benefits, such as health insurance, or contractual so benefits are not included.

Cost of Living

Frequently, business persons fail to examine their family living costs and needs. The average family in the United States requires approximately $33,000 per year for living expenses, according to USA Today. Recent studies from Minnesota, Kansas, and Cornell Universities, have shown that this amount is approximately $38,000 for farm families when income tax is included. A person must consider the family living expenses that are included in the business expenses. Some studies have shown that this can amount to 12 to 17 percent, including such items as fuel, clothes, and utilities. Most individuals find that large costs are easy to determine; however, small cost containment, particularly the category called "other," is frequently where cash is lost in family living expenses.

Stage of Personal Life Cycle

Further questions to be asked include where the individual and family are in terms of needs and goals. The spouse must consider employment opportunities, fringe benefits, stability of employment, and earnings potential. A question must be asked concerning how much income has been used from spousal employment to maintain the business enterprise. The possible cost of future educational needs must be addressed.

Retirement

Many producers fail to consider the retirement implications when selling the business. For example, a 50-year-old would normally have 15 years to go until retirement if he/she worked for someone else. In many cases, the business may not have generated a profit in previous years. If this is the case, then Social Security for retirement earnings is generally limited. It is suggested that a business owner complete a Social Security analysis for both the owner and the spouse. This analysis can be done by either contacting the Social Security Administration or completing a form that can be found at most local post offices. Also, the owner must realize that the business must have acquired sufficient wealth to generate earnings for the retirement years. Most producers and their spouses will live, on average, 15 to 20 years in retirement. At an annual living cost of $25,000 in retirement years, this could amount to nearly $500,000 needed in equity to provide a similar standard of living in retirement. Also, 60 percent of all health care costs occur in the last 6 months of life. Thus, nursing home cost, as well as confined medical care in later life, must be considered. Furthermore, family living costs increase 4 to 7 percent annually due to inflation.

Partial Liquidation

Sometimes business owners get frustrated and indicate that they are going to liquidate part of the operation and lease the remaining assets to someone else. For example, a beef producer may liquidate the herd and lease the farm to a neighbor. The business owner must assess whether the lease income will be sufficient to cover family living needs and pay any taxes and upkeep associated with the fixed assets. It is also important to attract a lessee who is responsible with the assets and will actually make the lease payments on a timely basis. In a partial liquidation or in a situation where land is left idle, consideration must be given to possible land use agreements and government payment requirements that may have been previously agreed upon. For example, a minimum number of livestock must be kept on the land in order to qualify for land-use taxation rates which lower the amount of property taxes.

Notification to Creditors

Before any liquidation, it is important to contact all creditors to obtain releases for security agreements and the details of payback requirements. Failure to comply with these agreements is a violation punishable by law. Also, it is important to keep creditors involved in the liquidation because they may know of potential buyers.

Cost of Sale

Frequently overlooked in the total or partial liquidation process is the cost of the sale itself. If an auctioneer or real estate broker is utilized, the fee can range from as little as 5 percent to as high as 10 percent of the asset value. Sale dates and method of sale must be carefully analyzed. Frequent cleaning, fixing machinery and buildings, and preparing livestock for sale can require both time and money from the owner. Personal experiences find that these costs generally run between 2 and 4 percent of the value of the assets being sold. Depending upon the size of the sale, between 150 and 250 hours can be spent by the owner in sale preparation. The cost of upkeep of the property until the sale is important. Idle equipment and structures deteriorate much faster than those in use.

Family Living Arrangements

When a sale of real estate takes place, a producer must consider housing arrangements which can amount to $40,000 to $50,000 in equity that must be set aside. If the producer is moving to another location, the cost of moving must also be considered.

Family Goals and Emotions

Any liquidation is an emotional event. Frequently, an owner's ego and a lifetime of work is being liquidated. It is sometimes useful to solicit the assistance of an outside facilitator to organize the sale and facilitate reasoning among family members. The facilitator's role sometimes involves helping to determine existing and future goals of both the business and family so that everyone has input and can establish a clear direction for the future.

In conclusion, the late 1990s will be a period of extreme volatility in business and agricultural economies. Hopefully, these ten steps will provide questions that business owners can think through if they are considering liquidation. It is often said it is easier to get in business than to get out of business. Maybe there is some validity to these comments!

Example Worksheets for the Calculation of Deferred Taxes on Agricultural Businesses*

Worksheet 1. Deferred Tax Liabilities on Current Assets

Current Assets (from Balance Sheet)				
Hedging account equity minus deposits		$ 0		
Notes and accounts receivable (collectable)		500		
Livestock and poultry to be sold				
Balance sheet value	$ 10,500			
Less purchase cost	4,000			
Net value		6,500		
Crops and feed	12,000			
Cash investment in growing crops	1,200			
Supplies		1,150		
Prepaid expenses (insurance)		485		
Total Current Assets That Would Be Taxed			(a)	$ 21,835
Current Liabilities (from Balance Sheet)				
Accounts payable		$ 4,200		
Medical and other personal expenses (only those that are deductible on federal income tax)		0		
Estimated accrued interest and expenses		1,600		
Estimated accrued tax liability:				
Property		0		
Real estate		0		
Employer payroll withholdings		0		
Income taxes (only state or local)		0		
Accrued rents and lease payments		1,250		
Total Current Liabilities That Could Be Deducted			(b)	7,050
Amount to calculate deferred tax liability on: (a-b)			(c)	14,785
Tax rate			(d)	35%
Deferred tax liabilities on current assets: (c x d)			(e)	5,175

* These worksheets were developed in cooperation with Feddie Barnard, Associate Professor at Purdue University, West Lafayette, Indiana.

Worksheet 2. Deferred Tax Liabilities on Other Assets

Marketable Securities		**Machinery**	
Market value	$ 0	Market value	$ 35,000
Less tax basis*	(- 0)	Less tax basis*	(- 20,000)
Difference	0	Difference	15,000
Ordinary tax rate	x 35%	Ordinary tax rate	x 35%
Deferred tax	0	Ordinary tax rate	5,250

Breeding Stock (Raised)		**Breeding Stock (Purchased)**	
Market value	16,000	Market value	0
Less tax basis*	(- 0)	Less tax basis*	(- 0)
Difference	16,000	Difference	0
Ordinary tax rate	x 35%	Ordinary tax rate	x 35%
Deferred tax	5,600	Ordinary tax rate	0

Real Estate		**Retirement Accounts**	
Market value	250,000	Market value	0
Less tax basis*	(- 75,000)	Less tax basis*	(- 0)
Difference	175,000	Difference	0
Ordinary tax rate	x 35%	Ordinary tax rate	x 35%
Deferred tax	61,250	Ordinary tax rate	0
		Plus interest penalty	0
		Deferred tax & int. pen.	0

* Tax basis is the original purchase price less accumulated depreciation.

Worksheet 3. Deferred Tax Liability Summary

Marketable securities		0
Breeding stock raised		5,600
Breeding stock purchased		0
Machinery		5,250
Real estate		61,250
Retirement accounts		0
Current asset		5,175
	Total deferred tax liability	77,275
	Value of assets	322,835
	Value of liability	122,050
	Deferred tax impact on owner's equity	38%
	Deferred tax impact on owner's assets	24%

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