

Selling Your Business? Plan Ahead and Consider the Tax Consequences

Within our wealth management practice, we often receive the ill-timed call from an owner who just signed a letter of intent to sell their business. Most owners spend the majority of their time operating their business and building its value, only to realize certain tax consequences erode that value upon sale. Ideally, a business owner needs to take the time and steps to preserve their business' value before, during and after its sale. Business owners should plan early and often for the following tax considerations, which have direct bearing on the owner's ability to retain value upon and after selling to the next owner.

1. Entity Structure

The form of business structure will impact the sale.

Flow-through tax entities include sole proprietorships, partnerships, S Corporations and Limited Liability Companies ("LLCs"). Each type of flow-through entity operates similarly from a tax perspective and provides greater flexibility when structuring sales of stock, assets and goodwill.

By comparison, C Corporations are subject to two levels of tax (at the corporate and individual level). This structure triggers tax at each level when selling company assets, and therefore limits flexibility when structuring sales.

Current S Corporations which previously converted from prior C Corporation status likewise find themselves subject to tax on built-in gains for 10 years following their conversion date. And, tax rules generally prevent owners from improving their position by converting from one form to another immediately before selling.

So, tax results will follow from corporate structure, and planning sooner rather than later is imperative.

2. Sales of Stock vs. Assets

Sellers of businesses prefer a stock sale because it treats the sale as long-term capital gain from a tax perspective. Stock sales also allow sellers to transfer corporate liabilities to buyers going forward. Sellers of C Corporations also prefer a stock sale because it avoids the two levels of tax due from asset sales.

By comparison, buyers of businesses prefer an asset sale because it provides them with a new basis for all corporate assets. Buyers also prefer an asset sale because it may insulate them from assuming liabilities of the prior owner. Or, it provides them with an opportunity to "cap" the amount of assumed liabilities before seeking indemnity from the prior owner.

Certain tax elections allow the owner of pass-through entities (S Corporations, partnerships and LLC's) to treat an asset sale

as a stock sale. Doing so allows the buyer to receive a new basis for all assets even when acquiring stock instead. This also allows the seller to transfer future corporate liabilities to the buyer. In return, the seller may recognize some ordinary income along with the capital gain provided by this election.

3. Allocation of Purchase Price

Federal tax rates on asset sales will vary from a low of 15% (long-term capital gains rate) to a high of 39.6% (highest marginal ordinary income rate). The class of each asset category and amount of purchase price allocated to it will impact overall taxes due.

The timing of business operations (from a cash or accrual perspective) may also impact the type of taxes due.

The types of assets subject to sale may include: cash, accounts receivable, inventory, equipment, real estate, intellectual property and intangibles (goodwill).

Accounts receivable generate ordinary income for cash-basis taxpayers—whereas they typically generate no gain for an accrual-basis taxpayer. Inventory generates ordinary income in excess of its basis. Depreciated assets generate recapture when their gain exceeds their basis but not their original cost. The recapture rates vary by asset type from long-term capital gain (e.g. intellectual property and intangibles), to 25% (e.g. real estate), and finally ordinary income rates (equipment).

Sellers and buyers are required to file an IRS Form 8594 to memorialize their agreed upon allocation of these various purchase allocation items.

4. Goodwill and Other Seller Payments

As noted above, sellers of a C Corporation (or an S Corporation with built-in gain) pay two levels of tax following asset sales and create no new basis for all company assets. Sellers therefore often make a variety of other payments to buyers through a stock sale. For instance, buyers who make “other seller payments” may obtain immediate or amortized deductions depending on the type of payment. Immediate deductions are available for payments related to consulting, interest and rentals. Amortized deductions are available for payments related to non-compete agreements and goodwill.

Another type of goodwill known as “personal goodwill” receives special long-term capital gain treatment. However, these payments are typically subject to additional IRS scrutiny because of their preferred lower rate.

5. Earnout Payments

Buyers often agree to pay an earnout to a seller who stays on with the company and helps set and meet future business goals. These earnout payments may carry undesirable tax consequences, though.

Portions of earnout payments are taxed as ordinary income instead of capital gain because of the imputed interest rules. Imputed interest (and therefore ordinary income treatment) increases over time depending on interest rate changes.

Sellers may elect the installment sales method to minimize some of this concern. That is, sellers may elect to push some of their basis into later years to offset the receipt of earnout payments at that time. However, there are two concerns when electing the installment sales method, including (1) greater tax up front because of less available basis, and (2) loss of basis if business goals—and therefore earnout payments—are not met.

6. Installment Sales

Sellers may allow the buyer to purchase the business over time as an installment sale. This may enable the seller to defer some gain into future years as the buyer makes the installment payments. However, the seller assumes the risk of acting as the bank in these cases and must rely upon the buyer to maintain business profitability enough to satisfy the payments. Some escrow structures may assist in minimizing exposure to that complication.

7. Tax-Free Sale Considerations

Sellers should consider whether they may be able to complete a tax-free transaction when selling a business. The IRS rules governing tax-free exchanges are complicated and beyond the scope of this overview discussion. However, the rules often require the seller receive between 40% and 100% of buyer stock from the transaction. Any cash leads to a gain for the seller and the buyer typically receives no new basis in company assets thereafter.

Tax-free exchanges apply to C Corporations and not to flow-through entities. Corporate reorganization prior to sale typically does not create a solution to that problem.

Sellers occasionally benefit from the tax-free rollover rules when they sell a qualified small business and invest in a new qualified small business per Internal Revenue Code Section 1045. For a review of this planning opportunity, see my prior whitepaper on this topic: *"Selling a Qualified Small Business? Consider Gain Exclusions or Rollovers"*.

Finally, sellers occasionally benefit from initially selling some company stock to an employee stock ownership plan (ESOP) for reinvestment on a pre-tax basis within that company stock plan. These complicated transactions require lead time and support

from third-party professionals such as appraisers, lenders and plan advisers.

8. State and Local Tax (SALT) Concerns

Depending on the location of the business, state and local sales taxes may be payable following its sale. Most SALTs are assessed at ordinary rates alone and apply to asset sales. Although these ordinary rates may not apply to stock transactions, a transfer tax on stock sales may be assessed as a revenue generating measure by some states. Failure to obtain the appropriate clearance "transfer tax stamp" before the transaction could result in delays and penalties (for both seller and buyer).

9. Estate Planning Considerations

Some sellers prefer to pass along some of the business value to family following its sale. Sellers therefore may choose to recapitalize the business at some point into voting and non-voting shares and then transfer the non-voting shares to family members or to trusts for their benefit. Sellers can structure family trusts as separate income tax payers or remain the income tax payer to preserve the transfer benefit while reducing their own estate further.

Prior planning is required to secure the benefits of business owner estate and gift transfer planning. Calling your attorney on the eve of a business sale can almost guarantee that these options will not be available.

Regardless of the goals and intent you have established for one day selling your business, remember to call your tax adviser at your earliest inclination. Both you and your tax adviser will appreciate it!



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