Buyers and Sellers

Tax Strategies for Buying and Selling Businesses

BY ROBERT BRISKIN

Among its many provisions, the Jobs and Growth Tax Relief Reconciliation Act of 2003 reduces the tax costs of selling a business.

CPAs can maximize the tax benefits for their clients through careful tax structuring of the selling entity; transferring the selling entity's assets; and properly allocating the purchase price among sold assets, intangibles and employment agreements.

The following are some available tax strategies for buying and selling a business.

AVOIDING DOUBLE TAXATION

Many businesses that are sold are owned by C corporations, which produces two levels of taxation in an asset sale: first at the corporate level on the assets' sale and second at the shareholder level when the net sales proceeds are distributed to the shareholders in a corporate liquidation.

Even after the 2003 Tax Act's tax reductions, this double taxation of the purchase price paid to a C corp in an asset sale produces a 53 percent tax rate after taking into account the effect of California tax. This combined tax rate will increase after the federal capital gain rate increases to 20 percent in 2009. This current combined 53 percent rate on an assets' sale gain should be contrasted with a stock sale where the one level of tax on the gain produces a low combined 21 percent federal and California capital gain rate.

These tax rates assume that there is no federal individual alternative minimum tax, which is at a maximum 28 percent federal rate. Because of California's high income tax rates, many clients will be subject to the AMT where they have a large amount of taxable gain from the sale of their business.

Selling Shareholders Will Prefer to Sell Their C Corp Stock Instead of Doing an Asset Sale to Produce Only One Level of Taxation. To avoid two levels of taxation, C corp clients selling their businesses will want to have a stock sale and not an asset sale, since a stock sale produces only a shareholder-level tax at low capital gain rates. However, the business' buyer may desire an asset sale to receive a stepped-up tax basis in the acquired assets. An asset sale also allows the buyer to avoid being obligated for potential tort and contract liabilities of the selling corporation. Additionally, an asset sale may have a California sales and use tax imposed on the sold assets.

The corporate buyer of stock could make a Sec. 338 election to receive a step up in the selling corporation's assets' tax basis, but the buyer would then have to pay a corporate-level income tax.

If Selling C Corp Has Operating Losses, It Can Avoid Gain on an Assets Sale. If the selling C corp has operating losses, it may be able to use these losses to shelter the gain on an asset sale, while still giving the buyer a stepped-up asset tax basis.

Avoid the Double Level of Taxation to a C Corp By Having Part of the Purchase Price Paid to the Selling Shareholders as Compensation or as Payment for a Covenant Not to Compete. An asset sale can be structured to treat some portion of the purchase price as payment to the selling corporation's shareholders for compensation or for a covenant not to compete, provided these payments are "reasonable" for tax purposes.

Consulting or employment agreement payments are immediately deductible when paid by the buyer, and are included as ordinary income by the selling shareholders when received. Salaries, however, will be subject to the FICA tax to both the paying (employer/buyer) and receiving (employee/selling shareholder).

Payments paid by a buyer under a covenant not to compete are ordinary income to the selling shareholders, but must be amortized by the buyer (and cannot be expensed) over 15 years, even though the covenant may be for a shorter period of time than 15 years. [Sec. 197(d)(1)(E).]

Use Qualified Plans to Defer Income Tax. Selling shareholders can set up qualified compensation plans to defer the tax on an employment agreement's payments.

Avoid the Double Level of Taxation to a C Corp by Treating Part of the Purchase Price as a Payment for Assets Owned by the Shareholders. Avoid the C corporate-level tax by paying the selling business' shareholders directly a license fee for shareholder-owned trademarks, trade names or franchises. License fees are taxed to the receiving selling shareholders at ordinary income rates. Shareholders owning real estate used by the business can either sell that real estate to the buying company (receiving capital gain treatment with the exception of recapture income) or the shareholders can rent that real estate to the buying entity (where the rents will be taxed to the receiving shareholders at ordinary income rates).

USING PASS-THROUGH ENTITIES

Owning the business in a limited liability company or S corp avoids the double level of taxation. California imposes an annual franchise tax of $800 on limited liability companies, plus an annual fee on income (before deductions) of $900 on income of $250,000, which maximizes at $11,790 annually on $5 million of income.

Convert Seller to an S Corp. If an S corp has been in existence for 10 years or more

(or was initially formed as an S corp), then the asset sale will not produce a federal tax at the corporate level under Sec. 1374. An S corp will still have the 1.5 percent California tax on its earnings, including gain on an asset sale. [California Revenue and Taxation Code Sec. 23802(b)(1)]. If a C corp is converted to S status, then there is potential built-in gains tax under Sec. 1374, loss of net operating loss carry-overs, and the inventory LIFO recapture tax.

Transferring Part of the Business to a Pass-through Entity. If the business is not owned in a pass-through entity, then prior to the business' sale clients can transfer parts of the C corp's business to either an S corp or a limited liability company to avoid the double level of taxation.

For example, if the client is developing a new manufacturing division or a new product line, the client can form an LLC or S corp to own this new division. The IRS would be hard pressed to impose a constructive dividend on the allocation of the corporation's opportunity to such new pass-through entity.

Prudent tax planning dictates that any transfer occur well in advance of the business' sale.

TAX-FREE REORGANIZATIONS

If the selling shareholders receive stock in the buying corporation in consideration of their business' sale, then the selling shareholders may be able to avoid recognizing gain under the tax-free reorganization rules of Sec. 368.

Types of Reorganizations. Selling shareholders can receive the buyer's stock tax free by a statutory merger (known as an "A" reorganization); the acquisition by the buying corporation of the selling corporation's shareholders' shares in exchange for the buying corporation's stock (known as a "B" reorganization); or the selling corporation's receipt of the buying corporation's shares in exchange for the selling corporation's assets (known as a "C" reorganization).

Effect of the Tax-free Reorganization Upon the Selling Shareholder. The selling shareholder's received buyer's stock has a stock basis essentially the same as the selling shareholder's sold business' stock. This inherent taxable gain in the received buyer's stock can be avoided if the selling shareholder or their spouse should die. Gain from the seller's receipt of cash or other "boot" in the exchange, whether treated as qualified dividend income or capital gains will still be taxed at the maximum 15 percent rate. The 2003 Tax Act added Sec. 1(h)(11), which taxes qualified dividend income at a maximum 15 percent rate. However, certain types of reorganizations limit or prohibit the sellers' receipt of non-stock (or "boot") consideration.

Effect of the Tax-free Reorganization Upon the Buyer. The buyer does not receive a step-up in the tax basis of the acquiring corporation's assets, according to Sec. 362(b), but can utilize its own stock (instead of cash to buy the business), which often proves to be a significant economic advantage to the buyer.

How Selling Shareholders Can Diversify Their Stock Holdings After the Tax-free Reorganization. One drawback of a selling shareholder receiving a large number of shares in the buying corporation is that this leaves the selling shareholder with stock ownership concentrated in one large block of stock. A solution to diversify the sellers' stock holdings is for the selling shareholder to contribute their stock (which they receive from their business' sale) to an "exchange fund," where different investors contribute large blocks of each investor's publicly traded stock into the exchange fund, which in turn results in diversification of stock ownership among the fund's investors.

AN INSTALLMENT NOTE

Instead of receiving cash for the sale of their business (which would be taxed in the year of receipt), shareholders may spread their sale's gain over several years by receiving back an installment promissory note. An installment note is permitted to defer gain recognition for either a non-publicly held stock sale or an asset sale. In an asset sale, Sec. 453 applies on an asset-by-asset basis. (Rev. Rul. 68-13, 1968-1 CB 195).

A shareholder may receive back an installment obligation for a corporation's asset sale, in complete corporate liquidation under Sec. 331 within 12 months, and not accelerate the recognition of gain inherent in the installment note for federal income tax purposes. Additionally, S corps are subject to the 1.5 percent California tax on the income from an installment note in the year of dissolution or as monies are paid on the note (California Revenue and Taxation Code Sec. 24672).

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A disadvantage of using an installment note for an asset sale is that recapture income may not be deferred by an installment note. Also, if the amount of all installment notes owed to the seller for the taxable year exceeds $5 million, interest must be paid on the deferred tax liability under Sec. 453A(a)(1). Therefore, if the Sec. 453A $5 million threshold applies, the selling shareholders should receive enough money to enable these shareholders to make tax interest payments to the IRS.

What if the Buying Entity is Willing to Pay the Selling Shareholders All Cash, But the Shareholders Still Wants to Defer Their Gain Over Several Years by an Installment Note? One tax planning strategy is for the selling shareholders to sell their stock to an unrelated (but trusted) independent entity in exchange for an installment note.

This third-party entity then sells the shareholders' stock to the buying corporation for all cash, recognizing no capital gains since the third-party entity's tax basis in the sold stock equals the amount of the promissory note by which the stock was purchased from the selling shareholders. The selling shareholders then are able to defer their sold stocks' gain by the installment note over several years, rather than recognizing all of their gain in the year of sale.

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