

“What’s Left In The Wallet”

Tax and Business Considerations When Buying or Selling a Business

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In most instances, when you sell your business, you are probably going to have to pay income taxes on the sale. What may come as a surprise is that ***the amount of taxes due from the seller, and the future tax benefits available to the buyer, can vary widely based upon how the transaction is structured.*** The key to achieving the most favorable results for both parties is to address these matters on the front end of the transaction, preferably at the time of the Letter of Intent (LOI).

Generally, three alternatives exist for structuring the ownership transition of a business: (1) a stock sale, (2) an asset sale, and (3) a reorganization or merger. The challenge is that the buyer and the seller will most likely have competing legal and tax interests and considerations within each alternative. Furthermore, a transaction can qualify to be treated as either taxable or tax-free depending upon how it is structured. For example, asset sales and stock sales will generally have immediate tax consequences for both the seller and the buyer, however, certain mergers and/or reorganizations can be structured so that at least a portion of the sale proceeds can receive tax deferred treatment. Additionally, in certain situations, a personal goodwill strategy can be implemented. This strategy can result in the saving of substantial taxes because personal goodwill is considered to be a capital asset subject to tax at capital gains rates. The benefit to the buyer is that personal goodwill may be amortizable by the buyer over a period of 15 years. Accordingly, even though both parties to a transaction generally must report the transaction on a consistent basis, there are a number of tax planning opportunities that allow both the buyer and seller to obtain specific economic and tax objectives without affecting the other party’s goals. (See later illustration)

From a buyer’s perspective, an asset sale is generally desirable because the buyer will receive a “step up” in the tax basis of the purchased assets equal to the purchase price paid. The result is that the buyer can depreciate the stepped up basis in the assets and potentially improve profitability in the early years of operations post-closing. However, for a corporate seller, an asset sale results in the imposition of a tax at the corporate level, and then another tax upon distribution of the proceeds to the shareholders. If the seller is a flow-through entity for tax purposes (Partnership, LLC, or an S Corporation), the selling owners will recognize both capital gain and ordinary income based upon the amount of the purchase price which is allocated to the “hot assets” - inventory, cash basis accounts receivable and assets which were subject to prior depreciation. Therefore, the allocation of the

purchase price by the buyer and the seller is extremely important in asset sales and in stock sales utilizing a Section 338(h)(10) election.

A Section 338(h)(10) election transaction is one in which the transaction is legally structured as a stock sale, but is treated as an asset sale for income tax purposes. Generally this involves the sale of the stock of an S Corporation, or the sale of the stock of a subsidiary corporation that was part of a consolidated group of corporations. For example, the seller in an asset or 338(h)(10) transaction will want to allocate as much of the purchase price to assets that generate capital gain, such as land, goodwill, or other assets with fair market values higher than their original tax costs. The buyer, on the other hand, will generally want to allocate as much purchase price as possible to the short life assets such as machinery and equipment, inventory, and prepaid expenses. If the transaction is structured as a straight stock purchase, the selling shareholders will pay tax at long-term capital gains rates provided that they owned the stock for at least one year. The downside to the buyer is that they will receive a cost basis in the “stock” purchased with no related step-up in the basis of the underlying assets.

Finally, if the seller is in a financial position whereby they can wait for a period of time before they actually receive cash, the transaction can be structured as a statutory merger or a reorganization. In these situations the buyer generally uses its own stock to pay for the purchase, and the recognition of gain is deferred until the seller begins to liquidate the buyer stock received in the transaction.

ADDITIONAL CONSIDERATIONS:

Escrows and Earn-Outs

The LOI should clearly establish any contingency to the payment of the purchase price, including any escrow and earn-out. The purpose of an escrow is to provide recourse for a buyer in the event there are breaches of the representations and warranties made by the seller. Typical terms include an escrow dollar amount in the range of 10% to 20% of the purchase price with an escrow period ranging from 12 to 24 months from closing. Earn-out provisions are typically tied to the future performance of the business with the sellers receiving the additional consideration only to the extent certain milestones are satisfied (i.e. achieving certain future revenue targets).

Non-compete Agreements

Within the context of a sales transaction, a covenant not to compete or solicit is a promise by the selling owners to not, for a specified period of time, engage in a business activity that is competitive with the buyer’s, or to lure away customers or key employees of the seller. Generally, to be enforceable, the restrictions must be reasonable in time and scope and be supported by financial consideration.

Contracts

To the extent that the seller's existing contracts have a prohibition against assignment, a pre-closing consent to assignment must be obtained from the contracting party. Generally, no such consent is required for a stock sale or merger unless the terms of relevant contracts contain specific prohibitions regarding the same.

Transaction Costs

Both the buyer and seller will usually incur legal, accounting, broker and other transaction costs. These costs may reduce the capital gain or ordinary income reportable by the seller, and the buyer will normally add the costs to the basis of the assets or ownership units purchased. However, it is possible that some of these costs may be deductible by the buyer on a current basis if certain parameters are satisfied.

Sales and Transfer Taxes

In many instances these costs are inadvertently overlooked and serve as an unpleasant surprise to the parties upon assessment. Additionally, these taxes are computed based upon the gross allocation of purchase price to certain types of assets rather than the gain amount. Therefore, they can increase total transaction costs by 5% to 10%. It is critical that the parties define up front whether the buyer or the seller will be responsible for these costs.

See Illustration on the Following Page

Edward F. Kidner is a partner with Dearson, Levi & Pantz PLLC, a Washington, DC based law firm with offices in the District of Columbia, Columbia, Maryland and Herndon, Virginia. His well-rounded career also includes leadership positions with a Big 4 accounting firm, a fortune 100 company, two full-service law firms, as well as six years as CEO and general counsel of a consolidated group of companies, all of which give Ed key insights to advise clients on a wide variety of complex business, legal and tax matters. As both an attorney and CPA, Ed has extensive experience in tax planning and structuring, divestitures, mergers and acquisitions, strategic planning, tax controversy, business planning, contract negotiations and finance. Ed has written several articles, is an accomplished public speaker, and is active in civic and professional organizations. Ed can be reached via e-mail at efkidner@dlpatlaw.com, or by phone at 410-491-0204.

Illustration:

Assume the following:

Seller Is A Small Manufacturing Business	Asset Basis: \$100,000
Sales Price: \$2,000,000	FMV of Machinery & Equipment: \$750,000
Stock Basis: \$50,000	FMV of Personal Goodwill: \$500,000

	C Corp Asset Sale	C Corp Asset Sale with Personal Goodwill	C Corp Stock Sale	Sole Proprietor Asset Sale
Sales Price	\$ 2,000,000	\$ 2,000,000	\$ 2,000,000	\$2,000,000
Corporate Tax	\$ 645,100	\$ 476,100	\$ 0	\$ 0
Shareholder/ Owner Level Tax	\$ 310,352	\$ 294,780	\$ 390,000	\$ 507,400
Total Taxes Paid	\$ 955,452	\$ 770,880	\$ 390,000	\$ 507,400
Net Cash To Owners	\$ 1,044,548	\$ 1,229,120	\$ 1,610,000	\$ 1,492,600

Note: Calculations ignore state taxes, transaction costs and the 3.8% Net Investment Income Tax

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