COMPLIANCE, FINANCE, LEGAL, TAX & ACCOUNTING

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Tax aspects of selling your business

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When you sell your business you may face a significant tax bill. In fact, if you're not careful, you can wind up with less than half of the purchase price in your pocket, after all taxes are paid! However, with skillful planning it's possible to minimize or defer at least some of these taxe

You will be taxed on the profit you make from selling the business. You may be able to cont the timing through the terms of the deal, but the IRS will take its share at some point.

make from the sale is taxed as ordinary income or capital gains. Profit received from the sale of the business assets will most likely be taxed at capital gains rates, whereas amount you receive under a consulting agreement will be ordinary income.

Allocation of sales price governs tax consequences

If you negotiate a total price for the business, you and the buyer must agree as to what portion of the purchase price applies to each individual asset, and to intangible assets such as goodwill. The allocation will determine the amount of capital or ordinary income tax you must pay on the sale. It will also have tax consequences for the buyer.

What is good for the tax picture for the seller is often bad for the buyer and vice versa, so the allocation of price to various components of the deal is frequently an area for negotiation and compromises.

The taxable amount at issue is your profit: the difference between your tax basis and your proceeds from the sale. Your tax basis is generally your original cost for the asset, minus depreciation deductions claimed, minus any casualty losses claimed, and plus any additional paid-in capital and selling expenses. Your proceeds from the sale generally means the total sales price, plus any additional liabilities the buyer takes over from you.

As the seller, you will probably want to allocate most, if not all, of the purchase price to the capital assets that were transferred with the business. You want to do that because proceeds from the sale of a capital asset , including business property or your entire business, are taxed as capital gains.

Under current law, long-term capital gains of individuals are taxed at a significantly lower rate than ordinary income. In fact, if you've held the asset for longer than 12 months, the maximum tax on long-term capital gains is 15 percent for qualifying taxpayers. (Taxpayers in the 10- and 15-percent tax brackets pay zero percent.)

If your business is a sole proprietorship, a partnership, or an LLC, each of the assets sold w the business is treated separately. (A corporation can also take this route, but it also has th option of structuring the sale as a stock sale.) So, the formula described above must be ap separately to each and every asset in the sale (you can lump some of the smaller items together, however, in categories such as office machines, furniture, production equipment etc.).

are treated as ordinary income and taxed at your normal rate.

After the sale, the buyer will be able to depreciate or amortize most of the assets that were transferred. Because different types of assets are depreciated differently under IRS rules, the buyer is going to want to allocate more of the price toward assets that can be depreciated quickly, and less of the price to ones that must be depreciated over 15 years (such as goodwill or other intangibles) or even longer (such as buildings) or not at all (such as land).

That's the basic story. But things are never that simple with the IRS. There are a number of qualifications to the rules, and issues that present planning opportunities for sellers (and buyers) of businesses.

Here are some that frequently come up:

- Ordinary income vs. capital gains.
- Gains on some of the assets being transferred may have to be taxed at ordinary income tax rates, rather than at the 15 percent maximum long-term capital gains tax rate.
- Installment sales. If you defer receipt of the purchase price to later years with an installment sale, you may be able to postpone paying tax on your gains until you receive them.
- Double taxation of corporations. For businesses organized as corporations, the structure of the deal as an asset or stock sale can have very different tax results.
- Tax-free reorganizations. Where one corporation is buying another, you may be able to structure the sale as a tax-free merger.

Please note that our discussion of tax aspects is a very broad overview, and presently covers only federal tax issues. It's essential to be aware of state tax issues. In some states, sales tax may apply to asset sales; some states tax stock transfers. Also, many states and localities impose transfer taxes on real estate or other assets. For more detailed information or advi pertaining to your individual situation and your state and locality, consult your tax adviser.

Capital gains result in lower tax liability

Some of these are tangible (such as real estate, machinery, inventory) and some are intangible (such as goodwill, accounts receivable, a trade name).

Unless your business is incorporated and you are selling the stock, the purchase price must be allocated among the assets that are being transferred. According to IRS rules, the buyer and seller must use the same allocation, so the allocation will have to be negotiated and put in writing as part of the sales contract.

Apportioning the price between assets can be a big bone of contention. The buyer wants as much money as possible to be allocated to items that are currently deductible, such as a consulting agreement, or to assets that can be depreciated quickly. This will improve the business's cash flow by reducing its tax bill in the critical first years.

The seller, on the other hand, wants as much money as possible allocated to assets on which the gain is treated as capital gains, rather than to assets on which gain must be treated as ordinary income. The reason is that the tax rate on long-term capital gains for noncorporate taxpayers is much lower than the highest maximum individual tax rate. Given that most small business owners who are successful in selling their company are in high tax brackets, this rate differential is very important in reducing tax liability.

Any gains on property held for one year or less, inventory, or accounts receivable are taxed at ordinary income rates. Amounts paid under noncompete agreements are ordinary income to you and amortizable over 15 years by the buyer, unless the IRS successfully argues they are really part of the purchase price. Amounts paid under consulting agreements are ordinary income to you and currently deductible to the buyer.

Depreciation recapture is ordinary income

Gain on depreciable personal property (that is, any property other than real estate), including amortizable intangible property such as business goodwill, is treated as ordinary income to extent that the gain that is equal to depreciation you've already claimed on those assets. In this way the depreciation is "recaptured."

Depreciation Recapture Example

You sold it 2 1/2 years later for $7,000. During the time you owned it, you claimed $6,160 in depreciation on the machine. Your basis in the property at the time of the sale was $3,840 ($10,000 - $6,160 = $3,840).

Your gain taxed as ordinary income is the lower of your depreciation deductions claimed ($6,160) or your amount realized from the sale minus your tax basis ($7,000 - $3,840 = $3,160). So, in this case all of your gains would be taxed as ordinary income.

If by some miracle, the machine had been sold for $12,000, the total gain would have been $8,160 ($12,000 - $3,840 = $8,160). Of this gain, $6,160 would have been taxed as ordinary income and $2,000 would have been taxed as long-term capital gain.

IRS allocation rules must be followed

As might expect, the IRS has come up with some rules for making allocations of the purchase price. Generally speaking, they require that each tangible asset be valued at its fair market value (FMV), in the following order:

1. Cash and general deposit accounts (including checking and savings accounts but excluding certificates of deposit);
2. Certificates of deposit, U.S. Government securities, foreign currency, and actively traded personal property, including stock and securities;
3. Accounts receivable, other debt instruments, and assets that you mark to market at least annually for federal income tax purposes. (Although there will be special limitations imposed on related party debt instruments);
4. Inventory and property of a kind that would properly be included in inventory if on hand at the end of the tax year, and property held primarily for sale to customers;
5. All assets that don't fit into any other category. Furniture and fixtures, buildings, land, vehicles, and equipment usually fall into this category;
6. Intangible assets (other than goodwill and going concern value). Copyrights and patent generally fall into this category.;
7. Goodwill and going concern value (whether the goodwill or going concern value qualifi as a section 197 intangible).

before moving on to the next class. Thus, intangible assets such as goodwill get the "residual value," if there is any. However, remember that FMV is in the mind of the appraiser. You still have some wiggle room in allocating your price among the various assets, provided that your allocation is reasonable and the buyer agrees to it. Your odds are even better if your allocation is supported by a third-party appraisal.

Spread out your tax bill via an installment sale

If you are willing to finance the sale of your business by taking back a mortgage or note for part of the purchase price, you might be able to report some of your capital gains on the installment method. This is good news, because the method allows you to defer some of the tax due on the sale until you get paid over the course of future years.

The installment method is used when you receive at least one payment for your business after the year of the sale. It can't be used if the sale results in a loss, but that rule hopefully will not come into play. More significantly, payments for many (or even most) of the assets of your business are not eligible for installment sale treatment.

Only capital assets are eligible for installment treatment

Only "capital gain income" can qualify for installment sale treatment. Anything on which gains must be treated as ordinary income will not be eligible for installment sale treatment. That includes payments:

- for your inventory;
- for accounts receivable;
- for property that's been used for one year or less;
- for any personal property to the extent of any depreciation that must be recaptured (a the amount of the depreciation recaptured.)

For all these items, you must pay tax on any gains in the year of the sale, even if you haven received payments for the items. Looking at it another way, in most cases only gain on asse

installment sale treatment. For older businesses, gain on intangible assets such as goodwill will also be eligible for installment sale treatment, because under the law prior to 1993 goodwill could not be depreciated or amortized (hence, there's no depreciation to be recaptured.)

How to use the installment method

To use the installment method, you begin with your allocation of the total purchase price for the business among all the assets you've sold with the business. Then, for each asset to which the installment method applies, you must compute your "gross profit percentage."

Your gross profit percentage is you gross profit on the asset divided by its selling price:

Gross Profit Percentage = Gross Profit / Selling Price Gross profit is your selling price (total cost to the buyer not including interest)minus the adjusted basis of the property, your selling expenses, and any depreciation recapture.

Gross Profit = (Selling Price - Interest) - [(Adjusted Basis) + (Selling Expenses) + (Depreciation Recapture)]

Then, each time you receive a payment, the principal portion of the payment (i.e., everything but the interest) is multiplied by the gross profit percentage to determine the amount that must be reported as taxable gain for the year.

If the buyer assumes any of your debt as part of the deal, the assumption is treated as a payment to you for purposes of the installment sale rules. If the buyer places some of the purchase price in an escrow account, it's not considered a payment until the funds are released to you, as long as there are some substantial restrictions on your ability to get the money.

If your deal includes an earnout provision under which you may be entitled to additional payments based on future performance, special rules apply. Please see your tax advisor for details.

Selling a corporation requires expert tax advice

in the corporation to the buyer, or you can have the corporation sell its assets to the buyer.

Tax considerations are the main reason that C corporation sellers usually prefer to sell their stock, while buyers prefer to buy the assets. With a C corporation asset sale, the seller will be taxed twice: the corporation will pay tax on any gains realized when the assets are sold, and then the shareholders will pay capital gains tax when the corporation is liquidated. In contrast, if you sell the stock, you'll pay capital gains tax on your profit from the sale, generally at the long-term capital gains rate.

From the buyer's perspective, however, asset sales are usually preferable. In an asset sale, the buyer's basis for depreciation is the allocated purchase price of the transferred assets. In a stock sale, the basis of the stock shares is stepped up to the purchase price of the stock. However, the buyer takes over whatever basis the seller had in the assets. If the seller had already depreciated some of the assets down to zero, the buyer can't claim any more depreciation deductions on them.

Clearly, the buyer would much prefer the stepped-up basis of an asset sale. One point to consider, when you negotiate the issue of a stock or asset sale with the buyer, is that your increased tax bill from an asset sale will usually be greater than the savings the buyer would get from such a sale.

A stock sale usually results in the lowest total amount of tax being paid to the IRS, and the most money left in the hands of the parties. Theoretically at least, you should be able to take advantage of a stock sale by adjusting your purchase price to reflect the future tax burden to the buyer.

Also, in a sale of stock, the IRS does permit the buyer to elect to have the transaction treated as a purchase of assets (i.e., buyer can get a step-up in basis for the assets), if the buyer pays tax on the difference between each asset's current basis and its fair market value in the year of the transfer.

Methods for delaying the second tax

Consider switching to an S corporation. With an S corporation, there's generally just one tax shareholders on either an asset or stock sale.

consider switching to an S corporation now. By doing so you can usually eliminate the double taxation on any appreciation after the date of the switch. If you go this route, be sure to get expert tax advice, and have an appraisal done at the time of the change.

Tax-free reorganizations defer tax

If your business is incorporated and you are selling out to a larger corporation, it may be possible to defer any tax due on the sale. How? By structuring the sale as a corporate reorganization, and accepting the purchaser's stock in exchange for your own business's stock. If you manage to comply with the IRS's extensive rules for these types of transactions, you won't be taxed on the value of the stock you receive, until you sell it at some point down the road. If you receive other property or tax in addition, however, you'll have to recognize taxable gain to the extent of this "boot."

This type of deal is only advantageous if you are selling out to a buyer whose stock is a good investment. Remember, you'll be exchanging a nondiversified investment over which you had control (your own company) for a nondiversified investment over which you may have little or no control.

Under Federal tax laws, you generally can't go out and immediately sell the buyer's stock; you may be required to hold it for as long as two years, or you will lose the tax-free status of the transaction. In two years, almost anything can happen to the value of the stock. If your buyer proposes structuring the deal as a merger or corporate reorganization, our advice is that you seek the advice of an attorney with extensive experience in this very complicated area.

Dissolve your business

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