

# Tax Implications in Selling a Business

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## Income Tax Implications of Selling a Business

- Sellers and Buyers often have competing interests with regard to taxation matters when negotiating the sale of a business.
- The following simplified examples are intended to identify some of these issues and also highlight some of the considerations that are important in managing the income tax cost of a sale.

# Disposing of a business may be viewed as either:

- A sale of assets

*or*

- A sale of an ownership interest\*

*\*Tax consequences are in general more favorable for a sale of ownership interest.*

## Sale of Assets

- Sole Proprietorship
  - Treated as a sale of separate assets
  - Gain or loss is calculated for each asset
  - Character of income or loss depends on nature of asset.

## Example 1 – Sole Proprietorship

Entity A							
Asset Schedule							
Assets	Original Cost	Depreciation	Tax Basis	Purchase Price Allocation	Gain on Each Asset	Tax Rate	Tax
Accounts Receivable	1,000,000	0	1,000,000	1,000,000	0	0	0
Furniture and Equipment	1,500,000	(1,000,000)	500,000	1,000,000	500,000	0.35	175,000
Vehicles	2,000,000	(1,000,000)	1,000,000	1,500,000	500,000	0.35	175,000
Land	2,000,000	0	2,000,000	3,000,000	1,000,000	0.15	150,000
Goodwill	0	0	0	1,500,000	1,500,000	0.15	225,000

An owner sells his sole proprietorship business, Entity A. The buyer pays him \$8 million for his receivables, equipment, vehicles and land. After adjusting for income tax liabilities, what is the owner's net gain after taxes?

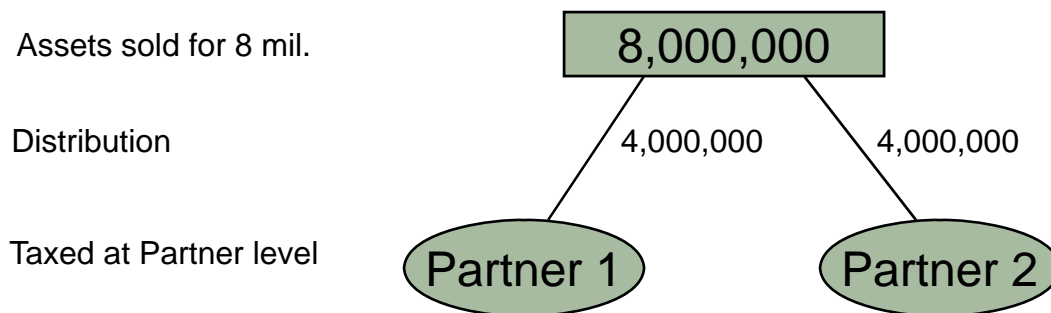
Net Gain After-Taxes       $\$8,000,000 - \$725,000 = \$7,275,000$

## Balance Sheet For Entity A

<b>Entity A</b>	
<b>Balance Sheet</b>	
<b>As of December 31, 20XX</b>	
<b>Assets</b>	<b>Dec 31, 20XX</b>
Accounts Receivable	1,000,000
Furniture and Equipment	1,500,000
Vehicles	2,000,000
Land	2,000,000
Accumulated Depreciation	(2,000,000)
<b>Total Assets</b>	<b>4,500,000</b>
<b>Liabilities &amp; Equity</b>	
Equity	4,500,000
<b>Total Liabilities and Equity</b>	<b>4,500,000</b>

## Sale of Assets

- Partnership or Multimember LLC
  - Gain\Loss flows through to members or partners
  - They report and pay tax on gain\loss
  - Distribution of cash proceeds does not cause double tax since basis is adjusted by gain\loss
  - Transaction looks same as sole proprietorship except amount is distributed between partners.



Tax consequences on sale similar to those of sole proprietorship

K1 items

Capital gain – 15%

Ordinary income – 35%

## Example 2 – Partnership

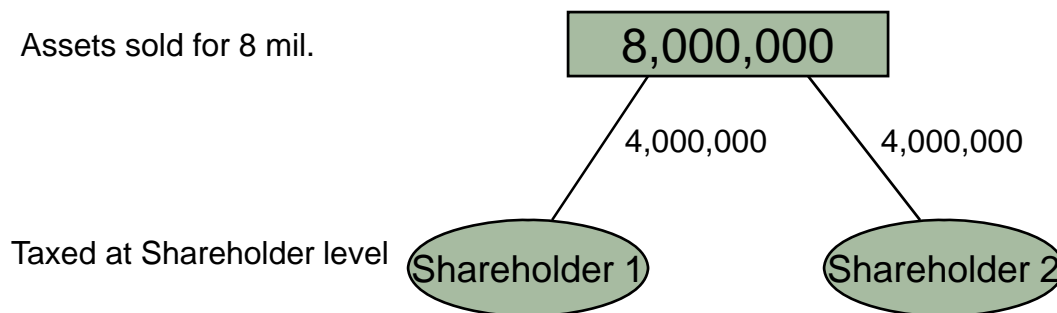
Entity A							
Asset Schedule							
Assets	Original Cost	Depreciation	Tax Basis	Purchase Price Allocation	Gain on Each Asset	Tax Rate	Tax
Accounts Receivable	1,000,000	0	1,000,000	1,000,000	0	0	0
Furniture and Equipment	1,500,000	(1,000,000)	500,000	1,000,000	500,000	0.35	175,000
Vehicles	2,000,000	(1,000,000)	1,000,000	1,500,000	500,000	0.35	175,000
Land	2,000,000	0	2,000,000	3,000,000	1,000,000	0.15	150,000
Goodwill	0	0	0	1,500,000	1,500,000	0.15	225,000

Suppose Entity A is an accrual basis partnership and has assets with book value at \$4.5 million. The partners are selling their partnership assets for \$8 million. What is the partners' net gain after taxes (assume 35% individual rate)?

Net Gain After-Taxes       $\$8,000,000 - \$725,000 = \$7,275,000$

# Sale of Assets

- **S- Corporation**
  - Gain\Loss flows through to shareholders
  - Shareholders report and pay tax on gain\loss
  - Distribution of cash proceeds does not cause double tax since basis is adjusted by gain\loss in accordance with stock ownership
  - Converted Corporations may owe a built in gains tax
    - Highest corporate tax rate
    - If conversion less than 10 years ago, re-analyze transaction



Tax consequences on sale similar to those of Partnership

K1 items

Capital gain – 15%

Ordinary income – 35%

## Example 3 – S- Corporation

Entity A							
Asset Schedule							
Assets	Original Cost	Depreciation	Tax Basis	Purchase Price Allocation	Gain on Each Asset	Tax Rate	Tax
Accounts Receivable	1,000,000	0	1,000,000	1,000,000	0	0	0
Furniture and Equipment	1,500,000	(1,000,000)	500,000	1,000,000	500,000	0.35	175,000
Vehicles	2,000,000	(1,000,000)	1,000,000	1,500,000	500,000	0.35	175,000
Land	2,000,000	0	2,000,000	3,000,000	1,000,000	0.15	150,000
Goodwill	0	0	0	1,500,000	1,500,000	0.15	225,000

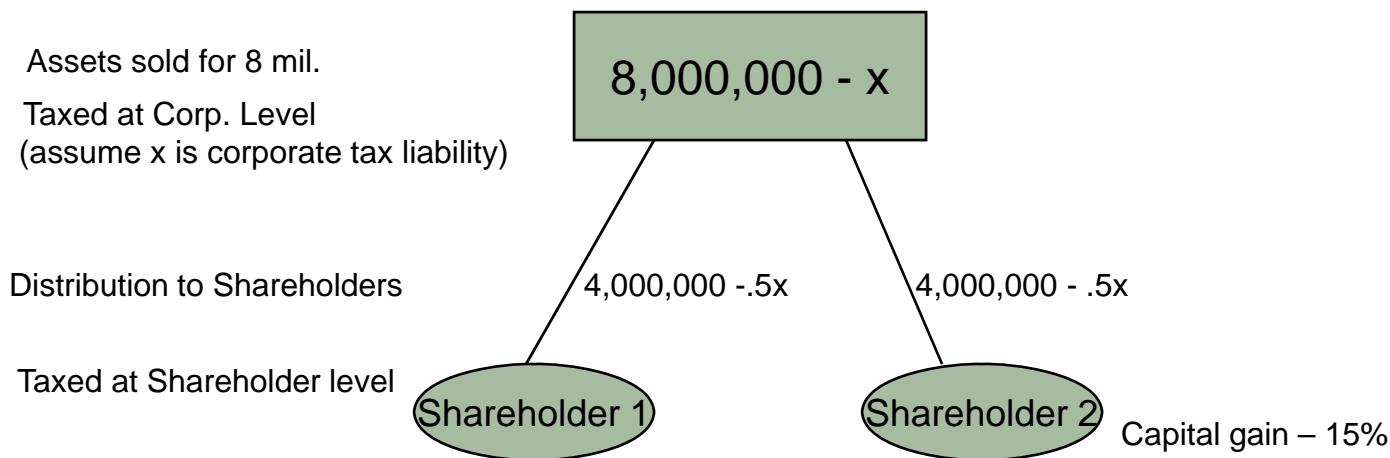
Suppose Entity A is an accrual basis S-Corporation and has assets with book value at \$4.5 million. The partners are selling their partnership assets for \$8 million. What is the shareholders' net income after taxes (assume 35% individual rate)?

Net Gain After-Tax                       $\$8,000,000 - \$725,000 = \$7,275,000$

## Sale of Assets

### ■ C- Corporation

- Gain is determined for each asset and tax paid by corporation
- Net cash after tax is distributed
- Taxed as dividend, return of capital, or capital gain to shareholder



# Example 4 – C- Corporation

Entity A							
Asset Schedule							
Assets	Original Cost	Depreciation	Tax Basis	Purchase Price Allocation	Gain on Each Asset	Tax Rate	Tax
Accounts Receivable	1,000,000	0	1,000,000	1,000,000	0	0	0
Furniture and Equipment	1,500,000	(1,000,000)	500,000	1,000,000	500,000	0.34	170,000
Vehicles	2,000,000	(1,000,000)	1,000,000	1,500,000	500,000	0.34	170,000
Land	2,000,000	0	2,000,000	3,000,000	1,000,000	0.34	340,000
Goodwill	0	0	0	1,500,000	1,500,000	0.34	510,000
Corporate Tax							1,190,000

Suppose Entity A is a C- Corporation and has assets with book value at \$4.5 million. The purchaser makes an offer on their assets for \$8 million. What is the shareholders net gain after taxes (assume 34% Corporate Rate)?

After tax bill is paid – remaining funds distributed to Shareholders – taxed at capital gain rate  
 $- 8,000,000 \text{ less taxes of } 1,190,000 = 6,810,000 * .15 = 1,021,500$

Total Corporate tax liability from sale – 1,190,000  
 Total Shareholder tax liability from sale – 1,021,500

Net Gain After-Tax                       $\$8,000,000 - \$2,211,500 = \$5,788,500$

## Sale of Business Interest

- Sole Proprietorship
  - No distinction between sale of interest or assets

## Sale of Business Interest

- Partnership
  - Sale of partnership interest results in ordinary income to partner for share of partnership's ordinary income assets; capital gain for remainder.
  - Results in same net cash as asset sale.

## Sale of Business Interest

- S-Corporation
  - Sale treated as sale of stock
    - Results in capital gain or loss to shareholder
    - In general, no corporate level consequences
    - Taxation at the ordinary income rates can generally be avoided
  - However, if purchaser is a nonqualified shareholder, S election is automatically terminated. S corporations may not:
    - ✓ Exceed 100 shareholders
    - ✓ Have shareholders that are non resident aliens
    - ✓ Have shareholders that are not natural persons
    - ✓ Have more than one class of stock

## Example 6 – S- Corporation

Entity A					
Stock Sale Schedule					
Equity	Stock Basis	Sale	Gain on Stock Sale	Tax Rate	Tax
Long Term Capital Stock	4,500,000	8,000,000	3,500,000	0.15	525,000

Suppose Entity A is an S- Corporation and has assets with book value at \$4.5 million. The sole shareholder is selling his shares for \$8 million. What is the shareholders net gain after taxes (assume 15% individual long term capital gain tax rate)?

$$\text{Net Gain After-Tax} \quad \$8,000,000 - \$525,000 = \$7,475,000$$

## Sale of Business Interest

- C-Corporation
  - Sale treated as sale of stock
    - Results in capital gain or loss to shareholder
  - No corporate level consequences

## Example 7 – C- Corporation

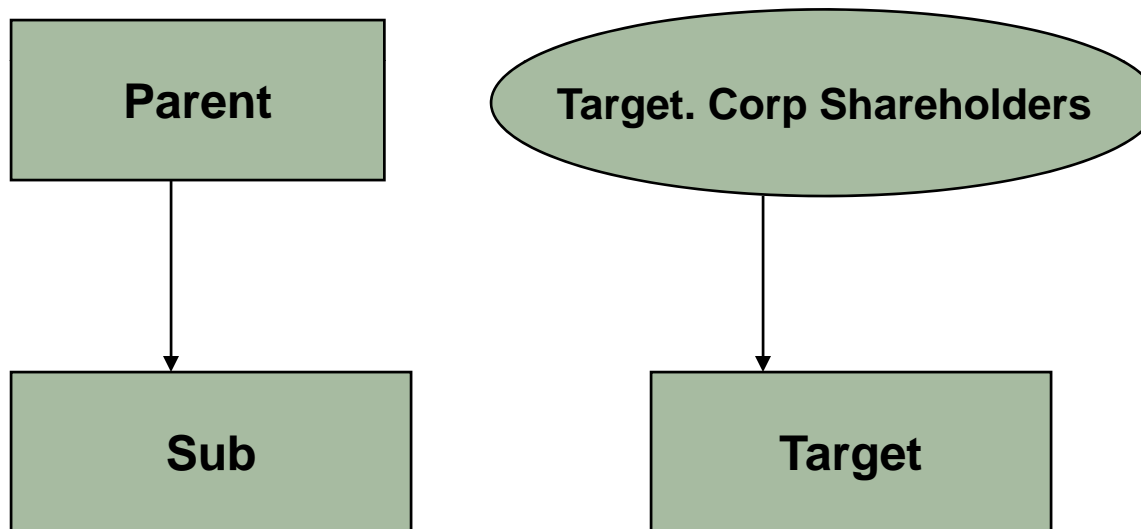
Entity A					
Stock Sale Schedule					
Equity	Stock Basis	Sale	Gain on Stock Sale	Tax Rate	Tax
Long Term Capital Stock	500,000	8,000,000	7,500,000	0.15	1,125,000

Suppose Entity A is a C- Corporation. The Shareholders of ACME desire to sell their shares to an acquiring corporation in a share buyout. Shareholder A has a basis of .5 million in Acme Stock and is offered 8 million. What is Shareholder A's net gain after taxes?

$$\text{Net Gain After-Tax} \quad \$8,000,000 - \$1,125,000 = \$6,875,000$$

# Triangular Reorganization

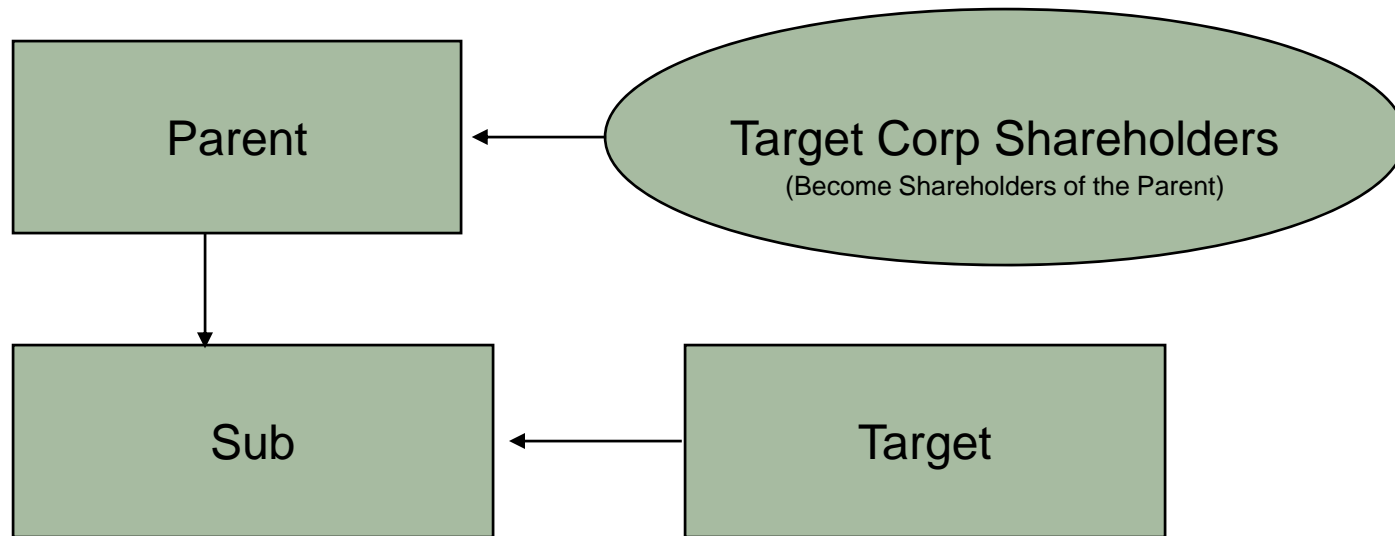
## Before the Qualified Triangular Merger



Ref. §368(a)(1)(B)

# Triangular Reorganization

## After Qualified Triangular Merger Stock for Stock Exchange



Ref. §368(a)(1)(B)

## Total Net Cash

	Sales Price	Tax	Cash
<b>Sale of Assets</b>			
Sole Proprietorship	8,000,000	725,000	<b>7,275,000</b>
Partnership	8,000,000	725,000	<b>7,275,000</b>
S- Corporation	8,000,000	725,000	<b>7,275,000</b>
C- Corporation	8,000,000	2,211,500	<b>5,788,500</b>
<b>Sale of Equity</b>			-
Sole Proprietorship	8,000,000	725,000	<b>7,275,000</b>
Partnership	8,000,000	725,000	<b>7,275,000</b>
S- Corporation	8,000,000	525,000	<b>7,475,000</b>
C- Corporation	8,000,000	1,125,000	<b>6,875,000</b>

## Sources



West Federal Taxation – “Comparative Forms of Doing Business”



RIA Checkpoint – Analysis/Federal Tax Coordinator