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The Tax Aspects of a Business Sale

Many business owners contemplate selling their businesses to start their retirement or to transition into another business. Many issues come to mind when considering selling a business. Among them are: how much is my business worth, who will buy it, and how much will I be left with once all of the taxes are paid? These valid considerations are extremely important when selling a business because the business owner is selling an asset that is worth as much or more than his or her house.

What makes selling a business particularly difficult is the fact that business sales are nearly invisible in the market. Consider this, look down the block where you live and elsewhere. How many for sale signs do you see and how much would you expect each house you see to sell for? Typically, people have an excellent idea and knowledge of the information and tax consequences concerning buying and selling houses, cars, furniture, vacation properties, stocks, bonds, etc. However, buying and selling a business is a different story!

Try the same action. Look at a business park or office building. How many businesses in the park or buildings are for sale and what would you expect to pay for the businesses. Chances are when you make this observation, you will not see one business for sale, know the selling price, how to arrive at a reasonable price, or what the tax consequences of the sale are. That is why it is important to thoroughly be aware of the consequences of the sale before selling a business.

This article will discuss the tax consequences of selling a business. The tax aspects of selling a business are as important as the asking price of the business itself! Among the tax considerations, whether you sell stock or assets of the company is an important concept to know and be familiar with. As a rule asset sales generally tend to result in more tax while stock sales will usually result in fewer taxes due for the seller.

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Asset Sales

Many sales of closely held businesses are asset sales. An asset sale, in this context, is a sale of a business by means of selling substantially all or all of the assets of the business. Assets include tangible and intangible, intellectual property, physical property, inventory, goodwill, real estate, land, equipment, furniture, fixtures, and anything else that would be considered to belong to the company.

Asset sales, as mentioned above, tend to give rise to higher tax liabilities to the seller than selling the stock of the company. On the other hand, to the buyer, an asset sale means increased tax benefits. The buyer buys the assets at a higher basis than what he or she would buy in a stock sale. Since asset sales result in higher tax liability for the seller and enhanced tax benefits for the buyer, it is common practice for the seller to ask for a higher price to compensate for the higher taxes.

Depreciation Recapture (asset sale)

When assets of the company are sold, depreciation expenses taken must be recaptured to the extent of depreciation taken or allowed. Depreciation recapture is a somewhat complicated tax concept in which the taxpayer pays ordinary taxes upon the sale of an asset to the extent of which depreciation was taken or allowed. The result is that instead of paying capital gains of 5/15%, the taxpayer will typically pay 28-35% on the sale of assets.

To illustrate the concept, imagine a machine shop that buys equipment for $100,000. During the course of its useful life, depreciation is taken in the amount of $100,000 against it. The equipment (purchased for $100,000) is then sold for $80,000 to a business buyer. At first glance many would conclude there should be no gain or it should be capital gain in nature. Unfortunately, there is gain due to depreciation recapture. In this instance, all $80,000 of the purchase price would be subject to depreciation recapture and it would be subject to ordinary tax at 35% as opposed to the beneficial rate of 15%. The result is that the seller pays an additional $16,000 in taxes while selling the machinery for less than what he purchased it at.

Ordinary Taxes (asset sale)

Away from depreciation recapture, other ordinary gains can arise. When selling inventory and/or accounts receivable, gains made when selling these items are subject to ordinary tax. The logic being that the sale of these assets would give rise to ordinary income had they been sold any other way.

For example, a cash basis taxpayer, which most of us are, has a drawer full of receivables with a face value of $100,000. Because the taxpayer is a cash basis taxpayer, the receivables are not previously taxed and are subject to tax liability. If the receivables are sold with the business, all $100,000 will be subject to ordinary gain to the taxpayer.

Capital Gains (asset and stock sale)

Along with depreciation recapture and ordinary gains, capital gains also arise during asset sales. Capital gains are normally taxed at preferential rates. If the company is a C corporation, low capital gains rates do not apply. The C corporation pays capital gains at the same rate as all other income they receive.

Since capital gains result in lower taxes, it is best to try to justify all the capital gains as possible rather than depreciation recapture or ordinary income.

With that said, S Corporations, LLC's, and sole proprietorships will benefit from realizing capital gains as opposed to any other gain. Any amount of money paid for an item beyond its original amount will qualify for capital gain treatment in an S corporation or LLC.

For example, a company buys $100,000 worth of equipment, as in the first example. It then deducts $100,000 of depreciation expenses. The company then sells the equipment for $110,000; the result is $100,000 in depreciation recapture (subject to ordinary income tax treatment) and $10,000 of capital gains subject to 15% taxes.

Since capital gains result in lower taxes, it is best to try to justify all the capital gains as possible rather than depreciation recapture or ordinary income. While it requires specialized knowledge to justify gains as capital gains as opposed to other gains, The Center specializes in minimizing tax liabilities for their clients. Be sure to contact The Center and Bart Basi for all of your needs concerning tax minimization.

Special Considerations for C Corporations

C Corporations have special considerations to ponder. Generally C Corporations are taxed twice. As such, any gain made from an asset sale will be taxed at the corporate level. Once it is taxed, any money distributed to the owner as a dividend is then again taxed at the rate of 15%. The result is that the owner and company may pay nearly 50% in taxes for gains made in an asset sale. It is best to TIME the sale of the business to close before December 31, 2010. Given the time it takes to sell a business, it is generally best to consider selling soon.

Additionally, C Corporations, as mentioned above, do not benefit from preferential tax rates which other entities benefit from. The capital gains of a C Corporation are figured in with the ordinary tax rate of the corporation. This can mean that capital gains generally will result in a tax liability of up to 35% at the corporate level alone.

There is also special case law now in existence reducing the double tax/capital gains burden of the C Corporation taxpayer in a business sale. Currently the tax interpretations allow for personal goodwill to be purchased by a buyer separate from the business transaction. Selling the personal goodwill, to the extent justified, allows the seller to escape a layer of tax to the extent of the personal goodwill sold and take advantage of the lower tax rates of an individual at 15%. This is a special, complicated tax issue. Sellers must deal with a specialist, knowledgeable in these types of transactions or else the IRS will disallow the personal goodwill. The Center is qualified and does handle many of these transactions involving the sale of C corporations.

Stock Sales

Stock sales differ completely from asset sales. A stock sale, in this context, is when a person or entity sells his or her stock to a third party for value. Stock sales tend to be the best tax scenario for a seller because the gain is primarily capital gain taxed at 15% no matter whether stock in a C or S corporation is sold.

In a stock sale, the seller will look to his or her basis in the entire company as opposed to each individual asset. Each individual asset's basis is not adjusted in a stock sale as opposed to an asset sale. As such, because the asset bases are not adjusted, the buyer does not gain a tax advantage and the seller does not suffer a detriment. Stock sales result in a less complicated and less costly tax scenario for the seller as opposed to asset sales.

Conclusion

Owners of closely held businesses face numerous issues when selling their businesses. Knowing the basic tax ramifications is generally not enough to ensure a good result. Sellers are best advised to not go it alone when selling to maximize the price they get, time the transaction, and achieve minimum tax liability. The Center, Bart Basi, and his staff routinely advise clients, performs valuations, and structures business sales to aide the buyer or seller to get the best and smoothest transaction. Contact us at (618) 997-3436 to learn more about saving taxes and getting more money for a seller of a business.