

# **Tax Strategies in Selling a Closely Held Business**

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## 1 Tax Strategies in Selling a Closely Held Business

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## 2 The Basic Structures

- Stock Transaction
  - Preferred transaction for Seller
  - Non-Tax reasons
  - Tax reasons
- Asset Transaction
  - Preferred Method for Buyer (most instances)
  - Non-Tax reasons for Buyer
  - Tax Reasons for Buyer
- Reorganization

## 3 Deal Basics--Corporations

- Stock Sale
  - Preferred Structure for Seller
    - Ability to walk away from ongoing business
    - Favorable tax treatment
    - Less of a need to obtain third party consents
  - Buyer (in most instances) prefers buying assets
    - In stock transaction no ability to increase basis of assets
    - Assumes historic liabilities
    - IRC Section 338(h)(10)

## 4 Tax Treatment to Seller in Stock Sale

- Seller pays capital gains tax on the difference between the Sellers basis in his stock and the amount realized from the Buyer. Same treatment for S-Corporation and C-Corporation.
- Subject to some exceptions, if the stock is sold at a loss, the loss will be a capital loss. Remember, capital losses can only be used against ordinary income to the extent of \$3,000 per year or to offset capital gains.

## 5 Tax Treatment to Buyer in Stock Purchase

- The Buyer of stock in a closely held business will receive a cost basis in the shares acquired, but will not be able to increase the basis of assets of the acquired corporation.

Exception is an election under IRC Section 338(h)(10).

## 6 The Three Stooges of Tax Code

- IRC Section 1244—Losses on Small Business Stock
- IRC Section 1202—Partial Exclusion of Gain From Certain Small Business Stock
- IRC Section 1045--Rollover Of Gain From Qualified Small Business Stock To Another Qualified Small Business Stock

## 7 Section 1244 Stock

- This Section allows ordinary loss treatment for the sale or worthlessness of certain stock of individual shareholders in a small business corporation. In order to qualify for 1244 treatment there are three requirements.
  - at the time the stock was issued, the corporation was a small business corporation (not the same as the Subchapter S definition (IRC 1361))
  - such stock was issued by such corporation for money or other property (other than stock or securities); and
  - such corporation, during the period of its 5 most recent tax years ending before the date the loss on such stock was sustained, derived more than 50% of its aggregate gross receipts from sources other than royalties, rents, dividends, interests, annuities and sales or exchanges of stocks or securities.

## 8 Section 1244 Stock cont.


- Section 1244 loss deductions are limited to \$50,000 per year and \$100,000 for joint filers. Selling the same stock for loss in two separate years, will allow you to use 1244 twice, but if the stock is worthless, it must be taken in the year in which it becomes worthless.
- Why isn't Section 1244 used more frequently?

## 9 IRC Section 1202

- Exclusion of Capital Gain from Qualified Small Business Stock. Section 1202 was added by the Revenue Reconciliation Act of 1993 allowing investors to exclude up to 50% of the gain from the disposition of qualified small business stock. Gain included is taxed at 28%.
- Qualified Small Business Stock is stock issued after Aug. 11, 1993 by a qualified small business in exchange for money, property, or services to such corporation. See IRC Section 1202(c)


## 10 IRC Section 1202 cont.

- A qualified small business means any domestic C-corporation if the aggregate gross assets of such corporation do not exceed \$50,000,000 at the time of or immediately after the issuance (See 1202(d) for a more precise definition).
- Also, during substantially all of the taxpayer's holding period, at least 80 percent of the value of the corporation's assets must be used in the active conduct of one or more qualified trades or businesses. Excludes most professional services.
- The amount of eligible gain is limited in a given tax year to the greater of: (1) \$10 million reduced by the aggregate amount of eligible gain taken in prior years or (2) ten times the adjusted basis of all qualified stock of the issuer disposed of during the taxable year.

11  **Section 1202 cont.**

■ **EXAMPLE OF SECTION 1202:**

In 2000, individual Taxpayer invests \$500,000 in a c-corporation engaged in manufacturing and receives qualified small business stock. In 2007, Taxpayer sells his stock for \$3,500,000. This results in a gain of \$3,000,000. Since Section 1202 would exclude 50% of his gain, the taxable portion is \$1,500,000. This \$1,500,000 gain is taxed at 28% for a total tax of \$420,000. Without 1202, the tax would be 15% of the total gain of \$3,000,000 which is \$450,000. So, the Taxpayer saves \$30,000. Note that if capital gain rates return to prior levels (e.g. 20%), the tax saving under this section jump to \$180,000 (assuming ATM does not apply).

12  **Why isn't 1202 used more frequently?**

- Must be a c-corporation and you must sell stock—Not an easy situation—perhaps other options?
- Must be in the right type of business.
- The taxable portion is taxed at 28% and long term capital gain rates are currently 15%, so under current tax rates there is not a significant amount of savings.

13  **IRC Section 1045--Rollovers**

- Section 1045 allows a taxpayer to sell qualified small business stock (See Section 1202 for the definition of a qualified small business) and rollover the tax gain into a new qualified small business stock within a 60 day period after the date of sale. The Taxpayer Relief Act of 1997.


14  **Section 1045 cont.**

- A taxpayer will qualify only if:
  - The taxpayer is not a corporation;
  - The taxpayer has held the qualified small business stock for more than 6 months at the date of sale;
  - The taxpayer elects Section 1045 treatment.
- Upon qualification, the taxpayer only pays gain on the sold shares to the extent that the amount realized from the sale of qualified small business stock exceeds the cost of the replacement qualified small business stock purchased within the 60 day period from the date of sale.

15  **Section 1045 cont.**

■ **EXAMPLE OF SECTION 1045:**

In 2000, individual Taxpayer invests \$500,000 in a c-corporation engaged in manufacturing and receives qualified small business stock. In 2007, Taxpayer sells his stock for \$3,500,000. This normally would result in taxable gain of \$3,000,000, but Taxpayer makes a timely election and purchases \$3,500,000 of qualified small business stock from another issuer. Taxpayer recognizes no gain and has a basis equal to the purchase price of the replacement qualified small business stock less the unrecognized gain as a result of Section 1045 (\$500,000).

16  **IRC Section 1045 cont.**

- So, why isn't Section 1045 used more frequently?
  - Must be a c-corporation and you must sell stock—Not an easy situation—perhaps other options?
  - Must be in a position to rollover all or most of your amount realized to defer taxes.
  - You have to acquire the replacement stock from the issuer, and not from another shareholder.

- There is not much time to find a replacement qualified small business stock.

## 17 Asset Sales

- Generally, the preferred method of acquiring a business for a Buyer. Unlike a stock acquisition, the Buyer gets a cost basis in the assets they acquire (I.R.C. 1012). If the Seller is an S-corporation, the Seller basically pays a “blended rate” on the assets they are selling—some items taxed at ordinary rates and others as capital gain. Note that if the Seller is a C-corporation they simply pay corporate rates (e.g. no capital gain treatment).

## 18 Issues with S-Corporation

- Assuming that an S-corporation has been in existence since formation, the biggest issues between the Seller and the Buyer in an asset deal relate to the allocation of the purchase price. As mentioned before, the Seller will want to allocate to items enjoying long term capital gain treatment (15%), while the Buyer wants to allocate more of the purchase price to items that might be taxed result in ordinary tax rates (e.g. inventory).
- Watch out for allocations to non-compete (except in limited circumstances), you would rather allocate to goodwill

## 19 Section 1060--Allocation

- Section 1060—provides that the Buyer and Seller use the residual method of allocating the cost and sales price of the individual properties transferred. The process is a step allocation to seven classes of assets.

## 20 Code Section 1060

- The Seven Classes of Assets are as follows:
  1. Cash and Demand deposits
  2. CDs, government, and marketable securities
  3. Accounts Receivable incurred in the ordinary course of business
  4. Inventory
  5. All assets not included in other classes (e.g. equipment, plant, undeveloped land)
  6. Intangible Assets, other than going concern value
  7. Goodwill and going concern value

Prior to Revenue Reconciliation Act of 1993, purchasers tried to avoid goodwill...now, it is all amortized over 15 years.

## 21 Negotiate

- While Section 1060 provides a mechanism to allocate purchase price among acquired assets in an acquisition, the practitioner should negotiate a schedule showing the allocation of purchase price. The seller wants to avoid post closing issues with the allocation and wants to ensure that the purchase price is allocated (to the extent possible), away from ordinary income items (e.g. appreciated inventory, depreciation recapture, etc.). It is better to have a consistent filing of Form 8594.

## 22 IRC Section 1031(h)(10)

This section allows certain transactions that are stock transactions for state law purposes to be taxed as if the assets were acquired. It really has no independent tax significance from an asset transaction, and it requires a joint election of both the buyer and the seller. This section is helpful when the buyer of an S-corporation wants to buy stock (for non-tax purposes), but wants to increase the bases of the assets of the acquired company.

## 23 Issues with either a dirty S-corporation or a C-corporation

- Perhaps the most difficult situation facing a tax practitioner in M&A work is trying to minimize taxes for a closely held c-corporation or a dirty s-corporation.
- What's a dirty s-corporation? It's an s-corporation that either has significant built in gains or accumulated earnings and profits. Remember, built in gains tax exists for ten years after making an s-election, the accumulated earnings and profits will remain until they are distributed.

## 24 The Problems

- C-corporations are subject to double taxation. This means that upon sale of the assets, the gain is taxed at C-corporation rates and then taxed again as dividends when distributed to the shareholders. This same problem exists to the extent of built in gains and AEP for a dirty S-corporation.

## 25 The Solutions

- Sell Stock—most buyers don't want to give up the tax advantages of acquiring assets
- Find a publicly held buyer who is willing to do either a stock swap (B-reorganization) or an Asset for Stock deal (C reorganization).
- Convert to S-corporation and wait ten years while electing to distribute AEP ahead of AAA. See IRC 1368(e)(3). This is a year by year election with shareholder consent.
  - Value the business upon conversion—HAVE A VALUATION REPORT PREPARED.
  - Old and cold is better
  - Watch out for LIFO
  - Loss of NOL carryforwards

## 26 More Solutions

- Allocate a portion of the purchase price to the sale of personal goodwill
- Try to allocate the purchase price away from built in gain assets
- Allocate a portion of the purchase price to consulting/employment agreements

## 27 Martin Ice Cream and Norwalk

- What is personal goodwill? Where does it come from? How can that benefit a C-corporation?
  - Martin Ice Cream—1998 case involving the sale of an ice cream distributor to Haagen-Dazs. The court held that the taxpayer's personal relationships, developed over decades of working in the industry, were not owned by the company but by the individual shareholder. Haagen-Dazs agreed and allocated the \$1.5 million dollar purchase price to \$300,000 of "records" and \$1.2 million to the owner of the company for "Seller's Rights."
  - As a result of this ruling, the owner realized capital gain from the sale of his goodwill,
  - This case does not fit every tax situation. Be cautioned that a non-compete between the owner and his own company would likely have resulted in a loss for the taxpayer.

## 28 Martin Ice Cream and Norwalk cont.

- Norwalk is another 1998 tax court case, this time involving the liquidation of an accounting firm. In this case, the accountant/shareholders did have expired employment contracts that restricted their ability to compete with the corporation. The Service argued that gain should have been recognized on the distribution of client lists, etc. to the shareholders in liquidation.
  - Court gave great weight to the non-existence of enforceable non-compete agreements
  - Also, to the personal relationship of the accountants with their clients.

## 29 Allocate Purchase Price to Non-Compete

- In the sale of a business, the buyer generally does not want the seller to compete against the buyer post closing.
- As a result, a portion of the purchase price can (and perhaps should) be allocated to a non-compete. A payment for a non-compete can be made to the shareholders, the selling corporation or both.
- A covenant would result in ordinary income treatment to the seller but it is better than the double taxation of the C-

*Does this NC become an asset?*

*Goodwill allocate only if owner sell corp*

corporation asset sale.

- See Miner for example of two shareholders, one sells stock to another with an oral non-compete... purchaser not allowed to amortize purchase price. Don't allocate post closing. Plan ahead. —

### 30 **Increase Employment Contract**

- One alternative to avoid issues with selling assets of a C-corporation is to pay more in post transaction employment contracts or consulting arrangements.
  - Seller does not always want to work
  - Still must be reasonable compensation
  - Additional risk for Seller
  - Good tax treatment for Buyer, but not without costs and potential for internal problems

### 31 **Last Thoughts on Selling A C-Corp or Dirty S-Corporation**

- First, finding the right buyer can save you if they are willing to do a corporate reorganization
- Second, look for situations where the owner has personal goodwill—have it valued
- Third, in the case of a dirty S-corporation, allocate the purchase price to assets that were acquired post conversion—this sounds obvious, but a corporate non-compete would be a good asset.
- Fourth, find out the value of the non-compete and allocate as much of the purchase price as you can justify.

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**Background:**

Mr. Strons has represented numerous buyers and sellers in mergers and acquisitions, including tax free reorganizations and restructuring. Furthermore, he represents closely held businesses in their corporate and tax planning matters and is involved in all aspects of business planning. Mr. Strons advises businesses and their owners on tax planning, succession planning, joint venture agreements, business structuring, employment contracts, and incentive compensation arrangements.

Mr. Strons has extensive experience with limited liability companies, limited partnerships, and S-corporations. Mr. Strons also represents individuals in their estate and personal planning, including the drafting of wills and trusts, family limited partnerships, business succession plans, grantor trusts, and irrevocable trusts.

**Education:**

University of Illinois, Champaign (Finance) 1990.

DePaul University College of Law J.D 1993

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**Other:**

Co-Chairman of the Firm's Corporate Practice

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Columnist for Naperville Sun "Ask a Lawyer" 2004-2005

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