Financial Fax is back!
Look for Mel Daskal's *Financial Fax* column in future issues of *Agency Sales* magazine.

Selling Or Buying A Business

by **MELVIN H. DASKAL, C.P.A., M.B.A.**; edited by **MORRIS SPECTOR, C.P.A.**

"The scientific theory I like best is that the rings of Saturn are composed entirely of lost airline luggage."

— Mark Russell

Overview

Not only may this be one of the most significant actions of your business life, but one that is also riddled with various complex tax ramifications. Since the vast majority of you do not often engage in such transactions, even the most sophisticated and successful businesspersons are frequently caught off-guard by all these brand new (to them) rules, angles, restrictions, implications, outcomes — and, above all, the tax costs.

C Corporation

You can either sell the stock of your corporation, or the assets, or a combination thereof. Further, this sale can be accompanied by various other agreements for the future — or not.

- If you simply sell the *stock* of the corporation, you (the seller) achieve the best of all possible worlds — long-term capital gain, subject to a maximum federal tax of 15%. The *corporation* continues to operate, unaffected by the stock sale itself or its purchase price — but with a new owner.
- The buyer has *no current tax deduction,* but simply owns stock with a tax basis equal to the purchase price. This is only significant in the event the stock is later resold.
- If you sell the assets of the corporation, the price you receive is *allocated* among the various assets — with different tax consequences for each category (class) for the buyer — but surprisingly *not* for the C corporation seller (see [d] below).

(a) Inventory is usually sold at cost and in bulk. There are no tax consequences unless the inventory is sold at a profit.

(b) Accounts receivable are usually purchased at net value. The buyer sometimes also assumes accounts payable dollar-for-dollar, as a reduction of the purchase price. Normally there are no tax consequences to either transaction.

(c) Depreciable assets are usually sold at a *profit,* since this is where the buyer wants to allocate most of the purchase price. The buyer can then depreciate

this purchase price over the useful life of the assets (frequently over five or seven years).

(d) To the seller company, gain on the sale of these assets is effectively taxed at corporate income tax rates (up to 34% federal). Why? Because there is *no reduced capital gain rate for C corporations* on the sale of *any* assets (tangible or intangible).

(e) ***Special rule:*** Any depreciation recapture must be reported in the year of the sale — even if the sale is being reported under the installment method.

(f) The seller C corporation, as explained above, also records the sale of intangibles as (effectively) ordinary income. The *buyer* must amortize and deduct their costs equally over 15 years — no matter what the intangibles may be (Internal Revenue Code Section 197). Such assets include goodwill, covenant not to compete, customer lists, contracts, trademarks and the like.

(g) Then, in most states, there will be *state* corporate income taxes to pay as well.

(h) In some cases, and in some states, there may be *sales tax* due on the sale of the depreciable assets.

(i) The seller corporation may continue operations, but usually only if it is to receive future income from the sale (e.g., an "earn-out" agreement that will make additional payments to the corporation if certain profit goals are met or exceeded in the future). Otherwise, the corporation, now holding nothing but cash, may be *liquidated.* The owner will then usually report long-term capital gain (cash received less cost of the stock) and owe personal federal/state income taxes. This is a case of the "double taxation" inherent in C corporations. First the *corporation* paid up to 34% federal tax on the sale — and now the *individual* shareholder will pay another 15% federal tax on the net proceeds (plus any state taxes).

Agreements with the *Individual* Owner of the Corporation

In many cases there are covenants not to compete and/or consulting agreements (sometimes described as "commissions") that are executed between the buyer and the *individual* owner of the corporation — in addition to the agreement relating to the corporate asset or stock sales. There may also be future salaries paid, if the owner stays on and continues to run the company.

- That individual usually receives taxable *ordinary income* from all such payments.
- Excluding salary, that individual then owes self-employment (social security) tax on all other income as well.
- The buyer has a 15-year intangible write-off in the case of the covenant not to compete (Section197), regardless of the *actual* length of the covenant.
- The buyer has a *current tax deduction* for payments classified as "consulting" or "commissions," and of course for any salaries paid.
- In some rather rare cases involving service-type corporations, the *individual* is paid for the "goodwill" related to the sale of his or her corporation. The theory is that the goodwill can really be attributed to that individual, since his or her personal service efforts created, and thus he or she really "owns," the goodwill. If so, this would be reported by that individual as a favorable long-term capital gain (subject to any IRS challenge). However, the buyer only has an intangible deduction spread equally over 15 years from the purchase of goodwill (again good old Section 197).

In some rather rare cases involving service-type corporations, the* individual *is paid for the "goodwill" related to the sale of his or her corporation.

There is* no reduced capital gain rate for C corporations *on the sale of* any *assets (tangible or intangible).

Unincorporated (Individual) Business

When the seller is not incorporated, the sale is always of the assets of the business, since there is no capital stock to sell.

(1) Inventory is usually sold at cost and in bulk. No tax consequences unless the inventory is sold at a profit.

(2) Accounts receivable are usually purchased at net value. The buyer sometimes also assumes accounts payable dollar-for-dollar, as a reduction of the purchase price. Normally there are no tax consequences to either transaction.

(3) Depreciable assets are usually sold at a *profit*, since this is where the buyer wants to allocate most of the purchase price. The buyer can then depreciate this purchase price over the useful life of the assets (frequently five or seven years).

(4) For the seller, the gain on the sale of the depreciable assets falls into two categories: (a) First, depreciation recapture at a special 25% federal tax rate; and (b) long-term capital gain for any remaining portion of the sale of these assets (maximum federal tax of 15%).

(5) ***Special Rule:*** Any depreciation recapture must be reported in the year of the sale — even if the entire sale is being reported under the installment method.

(6) The seller reports long-term capital gain for the sale of goodwill, customer lists, contracts, trademarks and the like.

(7) The *buyer* must amortize and deduct these costs equally over 15 years (Internal Revenue Code Section 197).

(8) In most states, there will be *state* corporate income taxes for the seller to pay as well.

(9) In some cases, and in some states, there may be *sales tax* due on the sale of the depreciable assets.

Then there are covenants not to compete and/or consulting agreements (sometimes described as "commissions") that are usually executed between the buyer and the seller. There may also be future salaries paid, if the owner stays on and continues to run the company.

- That individual seller receives taxable *ordinary income* from all such payments.
- Excluding salary, that individual then owes self-employment (social security) tax on all other income as well.
- The buyer has a 15-year intangible write-off in the case of the covenant not to compete (Section197), regardless of the *actual* length of the covenant.
- The buyer has a *current tax deduction* for payments classified as "consulting" or "commissions," and of course for any salaries paid.

S Corporations

These corporations are a special type that generally pay no corporate income taxes. The income "flows through" to the individual owners, and is reported on their individual income tax returns (thus avoiding the potential double taxation of C corporations). Therefore, you may regard such a sale under the *identical* rules just described for an unincorporated business, with one exception.

Built-in Gains Tax: You may ignore this threat if *either* of these conditions applies: (1) The corporation was never a C corporation, *or* (2) the corporation has been an S corporation for more than 10 years. For the rest of you, read on.

This tax is levied at the *corporate level* on S corporations that sell assets that appreciated in value during the years when the corporation was a C corporation. (This could include both tangible and intangible assets.) The tax is computed at the highest corporate income tax rate on such a gain. However, any net operating loss and/or capital loss carries forward from the prior years as a C corporation is now allowed as a deduction against the built-in gain of the S corporation.

Finally, since everything flows through to the individual shareholders in an S corporation, the amount of built-in gains passed through to them is *reduced* by the special tax paid by the S corporation on such gains.

Special Interest Rule

This special interest charge, payable to the IRS, only applies if *all* the following three conditions are met during the sale:

- The seller uses the installment sale method of reporting the sale.
- The seller is *not* a dealer of real or personal property.
- The face amount of all obligations are due to the seller *after* the close of the initial tax year of the sale exceeds $5,000,000.

In that case, an interest charge is imposed on the *tax that is deferred* as a result of reporting on the installment method, with respect to outstanding installment payments.

There is a special problem if it is a "contingent

IRS rules require the allocation of the purchase price of a trade or business among the assets acquired in proportion to their fair market values.

payment sale" (i.e., one in which the *total* purchase price cannot be determined in the year of the sale, such as an earn-out based on future profits). Then, in some cases there is a "judgment call" as to whether *or not* the amounts of the deferred obligations exceed $5,000,000 (which, of course, the IRS can challenge). As usual, there are all kinds of technical rules relating to contingent payment sales in general, as well as this special interest charge. See your tax advisor early if this could apply to you.

Asset Acquisition Statement

Says the IRS: "*The buyer and seller of the assets of a trade or business are bound by any written agreements allocating consideration of the transferred assets. However, any allocation that is not found to be fair market value will be disregarded.*" (Internal Revenue Code Section 1060)

In order for the IRS to determine that the buyer and seller are both reporting the transaction in the identical manner, the buyer and seller *must both* attach Form 8594 (Asset Acquisition Statement) to their income tax returns for the year of the sale.

This form requires that first you must list the amounts of the sale/purchase by class of assets. IRS rules require the allocation of the purchase price of a trade or business among the assets acquired in proportion to their fair market values. The allocations *must* be made in the following numerical order of the classes, beginning with Class I (this is the so-called "residual method"). Here is a *very brief* description of each class.

Class I. Cash.

Class II. Certificates of Deposit.

Class III. Accounts receivable and debt instruments.

Class IV. Inventory.

Class V. All other assets other than Class I, II, III, IV, VI and VII assets.

Class VI. All Section 197 intangibles except goodwill and going concern value.

Class VII. Goodwill and going concern value.

After these numerical listings, there are two final questions to answer. The first is to confirm that there is a written allocation agreed to by both parties *and* both parties have agreed to the allocations.

The second asks if there is also a side agreement involving the *individual* sellers (i.e., the shareholders, employees, etc.) such as: a consulting agreement, employment agreement, covenant not to compete, future individual earn-out payments, lease agreement or similar. If so, a schedule of the details must be attached to the Form 8594.

Compromises

The seller *always* wants long-term capital gain. The buyer *always* wants immediate or short-term tax deductions. The two positions are virtually opposite each other in most cases. The answer, of course, is to *compromise* so that each party gets *some* of what he or she wants.

Conclusion

Of course there are other entities such as partnerships, LLCs, trusts, etc., but you should be able to use certain of the preceding information, as it will apply to these other categories. A final caution: all these transactions *invariably* require an expert tax advisor to assist you. We generally find that at minimum, a team of a lawyer and a CPA is necessary. Sometimes, an outside expert in just the sale/purchase of businesses is also called in. Finally, there are some lawyers who do nothing *but* these kinds of transactions. So whatever you do, get a lot of expert help — and good luck! ❒

Watch for Mel's column next month on "Buy-Sell Agreements."

Copyright © 2007, Manufacturers' Agents National Association
One Spectrum Pointe, Suite 150, Lake Forest, CA 92630-2283 • Phone: (949) 859-4040 • Toll-free: (877) 626-2776 • Fax: (949) 855-2973
E-mail: MANA@MANAonline.org • Web site: www.MANAonline.org • All rights reserved. Reproduction without permission is strictly prohibited.

ABOUT THE AUTHOR:

Mel Daskal has spent his entire professional life specializing in manufacturers' sales agencies and their financial, tax and accounting problems and has represented over 400 such firms during his career. He was formerly the accountant for both MANA and ERA National and was a speaker at all MANA regional seminars and ERA national conferences for over 15 years. His accounting firm, Daskal/Spector Accountancy in Tarzana, California, currently has over 100 sales agencies as clients. He can be reached at (818) 907-1800 or (310) 556-1800.

While the information contained herein is believed to be reliable, its accuracy and completeness cannot be guaranteed. It is provided with the understanding that the publisher and author are not engaged in rendering legal, accounting or other professional service and that the author is not offering such advice in this publication. If legal advice, accounting advice or other expert assistance is required, the services of a competent professional person should be sought. The information and ideas in this article are intended to afford general guidelines on matters of interest to the readers; and they are frequently condensed for brevity and simplicity. Thus, they do not purport to present all the facts of any particular financial, tax, or legal discussion. The application and impact of tax laws can vary widely from case to case, based upon the specific or unique facts involved; and they may or may not be applicable to your particular tax or financial situation. Accordingly, this information is not intended to serve as legal, accounting or tax advice.

In preparation for this publication, every effort has been made to offer as current, correct, and clearly expressed information as possible. Nevertheless, inadvertent errors can occur and tax rules and regulations often change. Readers are encouraged to consult with professional advisors for advice concerning specific matters before making any decision and the author and publishers disclaim any responsibility for positions taken by taxpayers in their individual case, or for any misunderstanding on the part of the readers. The opinions expressed by Mr. Daskal do not necessarily reflect those of the publishers. IRS Circular 230 Notice: You are notified that any discussion of U.S. federal tax issues contained or referred to herein is not intended or written to be used, and cannot be used, for purposes of: (a) avoiding penalties that may be imposed under the Internal Revenue Code; nor (b) promoting, marketing or recommending to another party any transaction or matter addressed herein.