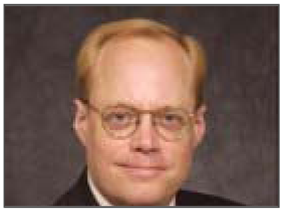
Forbes



Robert W. Wood
THE TAX LAWYER

Jul. 22 2011 — 9:27 am

Selling Your Business? Taxes Are Key

Business owners often talk of selling out to retire, move away, capitalize on a hot market or simply do something else. Right now, sales of small businesses are up. And sales mean taxes. See Sales of Small Firms Are Up. Big or small, if you have a business, taxes should influence—or even control—how you sell.

This is so whether you're talking about a home-based internet business producing $20,000 a year or a huge conglomerate producing $20 billion. Business sales are surprisingly consistent in concept, documentation, legal and tax rules across a wide spectrum of size and type. And taxes are inevitable.

First, consider the type of business entity being sold. If you operate a proprietorship, partnership, or limited liability company (LLC), you should generally be able to sell your business with a single level of tax. If you invested $20,000 to start your proprietorship or LLC business and later sell it for $50,000, your gain of $30,000 is taxed at your personal tax rate. The result is similar if that is your share of the sale of a partnership or LLC business.

Partnerships and LLCs are tax ***reporting*** entities but generally don't ***pay*** taxes. The individual partners—or in the case of LLCs "members"—pay tax on their percentage portion of the profits. A sale of a partnership or LLC business involves these same rules, so usually only one tax is collected at the partner/member level.

But if the business is a corporation the tax rules are more complex. Most corporations are "C corporations," meaning the corporation did not file an S election. "S corporations" are generally taxed more like partnerships. C corporations are taxed on their ***own*** income at a corporate tax rate (currently topping out at 35%). Corporate distributions are then subject to a ***second*** tax to individual shareholders.

This fundamental feature of the corporate tax law is what drives much of the discussion for how businesses are sold. Buyers inevitably want to buy the assets of a corporate business not its stock for two reasons. First, buying the stock incurs true successor liability for every past corporate liability. Buyers are able to avoid many target company liabilities by buying the corporate assets and leaving the corporate shell.

Second, buyers want to buy assets because they get a new tax basis in the assets. A higher basis means higher depreciation deductions in the future. In contrast, if the buyer bought the stock, it can't depreciate it and would generally be stuck with the low asset basis locked inside the company it purchased.

Sellers, on the other hand, prefer to sell stock, not assets. The reason is taxes. If a C corporation sells its assets and then distributes the sales proceeds to shareholders, the combined corporate and shareholder tax rate exceeds 50%. That hurts. A shareholder sale of stock might incur one tax as low as 15%.

Knowing this universal dynamic can help you plan ahead. If you have a C corporation and wait until you are ready to sell your business to discover these sale rules, you'll be sorry. While you may be able to orchestrate a tax-free deal, there's usually a high price for such arrangements. Plus, you dramatically limit the buyers that can qualify.

If you plan ahead and consider your business structure some years before you want to sell, you can probably produce a far more efficient tax result later when you do sell.

For more, see:

Choice of Entity Poses Tax, Liability Issues

Tax and Liability Dictate Business Form

Tax Rules to Know When *Selling* Property

Small Business Sales Pick Up

Sales of Small Businesses Increase

Small Business Sales Rise in Q1

IRS Publication 583, Starting a Business and Keeping Records

IRS: Sale of a Business

Robert W. Wood practices law with Wood LLP, in San Francisco. The author of more than 30 books, including Taxation of Damage Awards & Settlement Payments (4th Ed. 2009, Tax Institute), he can be reached at Wood@WoodLLP.com. *This discussion is not intended as legal advice, and cannot be relied upon for any purpose without the services of a qualified professional.*