PERSPECTIVE

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Fancy Footwork Won't Shake Taxes In UFC Sale

By Robert W. Wood

After months of sale or no sale debate, now it is official, as the 23-year-old UFC sells itself for $4 billion. The buyer is reportedly a group led by WME-IMG, with money from Silver Lake, Kohlberg Kravis Roberts, and a firm linked to Dell's Michael Dell. If the stories can be believed, the selling owners bought the rags to riches UFC for a $2 million investment in 2000. That was surely a bargain then, but it blossomed into a $4 billion company. With hard work, investment and some luck, that's quite a run up in value, which the IRS should like quite a lot.

UFC's main owners are Frank and Lorenzo Fertitta, who are to stay on as minority investors. Their timing was excellent, but after years of fights with state athletic commissions, the legitimacy of the sport is no longer in doubt. After all the denials about UFC being on the block, managing the process and public perceptions must have been difficult.

Dana White, who evidently owns roughly 9 percent, repeatedly said there was no sale, though he did say if someone showed up with $4 billion, they could talk. For business owners, sale talks can be disruptive, but this disruption was extraordinary. Months ago there were stories flying about UFC accepting bids, even saying a deal was finalized.

The sale of a business is usually a big event in the owner's life, financially, emotionally and in other respects. Taxes are key to business sales, but *who* pays them? Some business owners work for decades and sell a business only once. Others build and sell multiple times, buying or selling businesses every few years.

You might conduct business in a proprietorship, partnership, limited liability company (LLC) or corporation. Regardless of form, a fundamental question is whether you are selling the stock or assets of the business. The stock or assets question implies you are operating in corporate form. In that case, you could sell the stock or the corporation could sell its assets.

If the business is operated as an LLC, you could sell membership interests (the units the members of the LLC hold) or the LLC itself could sell its assets. If the business is operated as a partnership (whether general or limited) the sale could be made by the partnership (a sale of assets). Alternatively, the partners could sell their partnership interests.

You might think all these avenues lead to the same place, but they can come out quite differently. If you sell corporate stock, you change who owns it, but the company still owns its assets. The same is true if you sell a partnership interest or LLC membership interest.

Even if all the owners sell their interests, the entity still owns the assets. If a partnership, LLC or corporation sells assets, the purchase price is paid *to the entity*. Whether or not the money is distributed to the shareholders, partners or members, the payment has tax effects.

To assess it, you'll need to know the tax basis of the assets in the hands of the entity. The tax basis is the purchase price the company paid for the assets, less accumulated depreciation, plus certain adjustments. If a business sells its assets for $5 million, to determine taxes you need to know the business' basis in these assets. If its basis is $2 million, there's a $3 million gain. If its basis is $6 million, there's a $1 million loss.

Sometimes, this kind of basis is known as "inside" basis, meaning the tax basis inside the entity. Depending on the type of business entity, this gain may be taxed to the entity or to the partners or members. For example, if a C corporation sells its assets for $5 million with a $2 million basis, that $3 million gain will be taxed to the corporation at up to 35 percent. That will leave only about $3,905,000 for distribution to shareholders.

If an LLC or partnership sold the assets for $5 million at a $3 million gain, there is no tax at the entity level. The full $5 million passes through to the owners who pay their share of the $3 million gain. If you think C corporation treatment is better because the entity pays the tax, think again.

After all, when shareholders of a C corporation receive distributions, they *too* must pay tax at their individual rates. Of the $3,905,000 distributed to them, how much tax they pay depends on their basis in their shares and other variables. But they pay two levels of tax. The partners of a partnership or members of an LLC are better off because they only pay one level of tax, not two.

There is only one level of tax if the business owners sell their interests in a corporation, partnership or LLC. To determine whether there is gain or loss and how much, you'll need to know the owner's basis in the ownership interest. With an LLC or partnership, this is sometimes referred to as "inside basis," to distinguish it from the "outside basis" that the entity has in its assets.

How about UFC's taxes? Not every business owner plans ahead, but it seems reasonable to believe that UFC is slickly organized and run. Thus, a single level of tax seems almost a certainly. It also seems likely that the owners have mostly capital gain, not ordinary income. At federal rates of 39.6 percent for ordinary income, or 20 percent for capital gain, that's a big spread.

They probably also face the 3.8 percent net investment income tax that helps pay for Obamacare, but 23.8 percent is still much better than 39.6 percent. Add state income taxes, and note, anyone in California pays up to 13.3 percent *with no distinction between ordinary income and capital gain*. If you add it up, the government should end up with considerably more than a billion dollars out of this deal. Of course, there should be considerable cash left over.

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