PERSPECTIVE

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Like Lucas, Sell Out This Year?

By Robert W. Wood

2012 is fast drawing to a close, but there is still time to emulate George Lucas. He recently sold to Disney for $4 billion of cash and stock, but with current tax rates, you don't have to be in the billions for a sale of a company, real estate, or stock to capture tax savings before year-end. After all, the 15 percent capital gain rate ends Dec. 31, soaring to 23.8 percent in 2013.

That's one reason this year-end will be a busy one. With tax rate spreads like that, you can save some serious money—even if you aren't quite as successful as George Lucas. Business owners and professionals often talk of selling out to retire, move away, capitalize on a hot market or just do something else.

Big or small taxes influence how you sell a business. Business sales are surprisingly consistent from the biggest to smallest. First, consider the type of business entity.

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. But if the business is a corporation, the tax rules are more complex.

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

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

Second, buyers want to buy assets to get a new tax basis in the assets. A higher basis means higher depreciation deductions in the future. If the buyer buys stock, it can't depreciate the stock and would be stuck with a low asset basis locked inside the company.

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

If the business is operated as an LLC, you could sell membership interests, or the LLC itself could sell its assets. If a partnership, LLC or corporation sells assets, the purchase price is paid to the entity. The entity may or may not thereafter distribute the sales proceeds to the shareholders, members or partners.

But either way, 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, minus accumulated depreciation, plus certain adjustments.

For example, suppose the business entity sells its assets for $5 million. To determine taxes you need to know the business' basis in these assets. If the company's basis in the assets is $2 million, there's a $3 million gain. If the company's basis in the assets 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 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 can pass through to the owners who pay their pro rata 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 from the corporation, they 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.

Knowing these tax rules can help you plan ahead. If you have a C corporation and wait until you are ready to sell your business to discover these 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 long before you want or have to sell, you can produce a more efficient tax result when you do.

Robert W. Wood *is a tax lawyer with a nationwide practice (www.WoodLLP.com). The author of more than 30 books including "Taxation of Damage Awards & Settlement Payments" (4th Ed. 2009 With 2012 Supplement www.taxinstitute.com), 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.*