PERSPECTIVE

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Selling a Business Triggers Taxes for Owners, Company or Both

By Robert W. Wood

Are you selling a business, or perhaps helping a client to sell a business? In any of these circumstances, it pays to think about taxes first, long before you ink documents. In fact, you can say the same thing — think taxes first — about selling many investments, at least if the investment (real estate for example) is sitting in a legal entity.

The sale of a business is usually a big event in the owner's life. Many people work for decades or even a lifetime before selling out. Others build and sell multiple businesses every few years. There are also mega and serial buyers and sellers like Warren Buffett, one of the most tax savvy of all.

The buyers and sellers vary, but there is often at least one common denominator: taxes. Selling a business almost always incurs one tax, and often two taxes. The business entity itself may be taxed, and the shareholders, partners or members may too. You generally hope to limit your tax hit to one tax, not two. And if you are really lucky or clever, paying no taxes at all is obviously even better.

That no tax win may be possible if you are swapping stock in one company for stock in another on the right facts, where you are rolling your gain into a reorganized company. Warren Buffett has often managed to roll over investment gains without triggering a tax. After all, earning a return pre-tax is always better than earning post-tax. That's the premise behind 401(k)s and IRAs.

The mechanics of sale are important to figuring out the taxes. If your business is operated as an LLC, you could sell membership interests, or the LLC itself could sell its assets. If the business is a partnership (either general or limited) the sale could be made by the partnership itself (a sale of assets). Alternatively, the partners could sell their partnership interests.

You might think that all these avenues would lead to the same place. Not when it comes to taxes. If you sell corporate stock, you change who *owns* the company, but the company is still in place, and still owns its assets. The same is true if you sell a partnership interest or LLC membership interest. Even if *all* of the owners sell their interests, the entity still owns the assets.

To see the tax differences between these mechanical variations, you need to follow the money. If a partnership, LLC or corporation sells its assets, the purchase price is paid to the entity, which may (or may not) distribute the sales proceeds to the owners. Regardless, the sale will have tax effects. To assess it, you need to know the tax basis of the entity's assets.

The tax basis is the company's purchase price for the assets, less accumulated depreciation, plus certain adjustments. Say a company 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 called "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 its owners. 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 21 percent. That will leave less money to distribute to share-holders.

However, if an LLC or partnership sells its 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 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 *also* pay taxes at their individual rates. That is a *second* tax.

How much tax they pay of the cash distributed to shareholders 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 pay only one level of tax. Warren Buffett is tax savvy, often charting Berkshire Hathaway through deals that are tax free in whole or in part.

In fact, shrewd business deals that deftly avoid taxes are a kind of trademark for the billionaire. There are many examples, including when Berkshire turned over $4.7 billion in Procter & Gamble stock in exchange for its Duracell battery business. The latter got a $1.7 billion cash infusion. Normally, selling stock is taxed, but this deal sold without selling. The tax savings were probably over $1 billion.

Berkshire also swapped shares in Phillips 66 in exchange for its pipeline-flow business. These are exchanges of shares structured as a tax-free reorganizations. That way, Mr. Buffett deftly sidestepped taxes. Mr. Buffett saves taxes personally too. For example, he usually makes donations with appreciated stock to the Gates Foundation.

Why not donate cash? By using highly appreciated stock, he can claim a tax deduction based on the current fair market value of the stock. Yet, he never has to pay the income tax on his big gain.

Returning to smaller and simpler deals, *any* business sale should involve tax planning. The sale of a family business, whether large or small, is a perfect example. The mechanics and the resulting taxes can make a huge difference.

Many small business sales involve paying one or even two layers of tax. It pays to consider whether any of these taxes can be avoided entirely or at least deferred into the future. So, plan any transaction with care from the start. If you wait until after the closing to worry about taxes, you may be sorry.

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