Legacy ADVISORS GROUP

M & A UPDATE®

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Taking Capital Losses

Bart A. Basi, CPA/Attorney at Law
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Introduction

Lately, the stock markets have been battered by news of recession, low earnings, unemployment numbers, negative leading indicators, and other bad economic news. This has lead to substantial capital losses for most investors across the investment spectrum. Those holding industrial stocks, financial stocks, transportation, and energy stocks are reporting their portfolio values have been cut essentially in half. Some holders of retail and financial stocks have seen individual stocks go from being stocks of respectable value to being worthless or near worthless.

Unfortunately, a lot of value has been lost by many investors. Fortunately, tax benefits abound when misfortune strikes. A stock that has been battered in value or has become worthless still contains value for those holding the stock. The value comes in the form of a tax deduction.

Netting

Fortunately, for investors any capital losses are first netted against capital gains. Capital gains may be few and far between right now, but for those holding appreciated capital assets such as that rare stock that is up right now, metals, and the like, it may be the best time to sell, take the gains and recognize an equal amount of loss to offset the gains. The end result is a zero tax bill.

For example, if an investor owns something such as farmland purchased during the 1980's, as of right now, the property will be substantially appreciated. If the investor holds stock containing losses, the same investor can sell the farmland at a large gain and net that gain against the losses on the stock. Potentially, a farm owner can take a million dollar gain and walk away owing nothing in taxes when netting the two transactions.

Annual Limit

Despite the potential for large losses in the multi-million dollar range, there is a limit to which individual investors can deduct capital losses if no gains exist to net the losses against. The deduction is limited to $3,000 per year. The $3,000 loss can be deducted against income and capital gains.

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A CASE STUDY

The Tax Court held that the value of a decedent's interest in a closely-held corporation was properly calculated by using discounts to reflect lack of control, marketability, and built in capital gains. The decedent owned a very small minority interest in a well established corporation with very large potential for capital gains. When the decedent passed away, the estate valued the interest. The IRS argued the value was too low and discounts were unreasonable as calculated. In Court, the Tax Court agreed that the discounts were too deep, but allowed the control and marketability discounts along with a reduction in value for capital gains.

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This means any losses, potentially millions of dollars in losses, must be used over the course of many years in the future against capital gains. In some instances, the losses are so great that any perceivable human life span of capital loss deductions will not exhaust the potential losses some investors have endured. This is why timing capital losses against gains is critical, otherwise you could potentially have unused losses for the rest of your life.

Worthless Stock

The Internal Revenue Code permits deductions for stock which becomes completely worthless during the year. Stock is deemed to have been sold on the last day of the tax year for which its value has gone to zero. For stock to be worthless within the strict definition of the Internal Revenue Code, its value must be zero. As a practical matter, many stock's value has gone to a price of a penny or two a share. A well known example of this is Circuit City. According to the definition, the stock may not qualify strictly as worthless stock, but for most practical reasons, stock of companies that have filed for bankruptcy may be in fact, worthless for deduction purposes. To be worthless in a practical sense, the company must be in a circumstance where the company and its stock will not recover, the liabilities must exceed asset value, the business must be in cessation, or a reasonable financial statement analysis would reveal no hope of ever being solvent.

Finally, if your stock has reached a point where it is beyond hope, you can sell the stock for pennies. Selling the stock will define the transaction as a stock loss and you will escape the gravity of the slippery definition of "worthless stock".

Conclusion

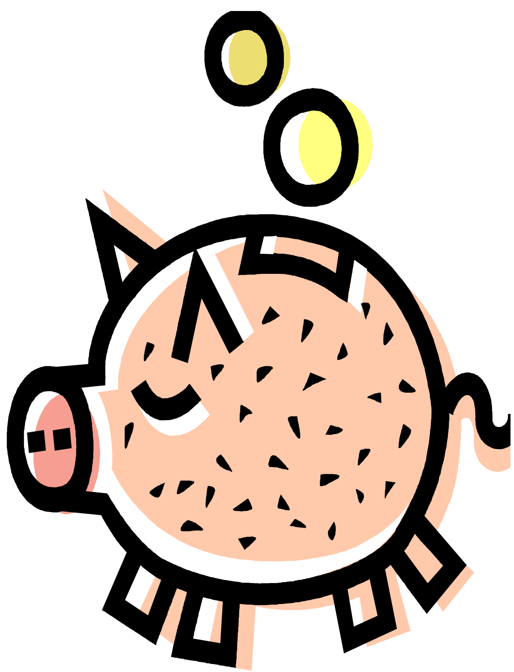
The stock markets have seen their share of losses this year and the previous year. Exercising your losses for tax deductions can lessen the impact on your finances. Timing is critical in that you cannot deduct losses of greater than $3,000 per year in excess of your gains. Holding stocks until the losses are deductible is one way to time losses in your favor. The Center routinely advises people on matters involving capital gains and losses and the tax ramifications, business valuation, and business succession matters. For an analysis of your situation, contact the specialists at the Center for more information.

Dr. Bart A. Basi is an attorney, CPA, and the Senior Advisor of The Center for Financial, Legal & Tax Planning, Inc, a full service company specializing in financial, legal & tax matters. Basi is a nationally recognized author, lecturer, and advisor on how to structure deals to minimize taxes. Tax structure makes the difference between getting the deal done and watching the deal fall apart. Many of you may be familiar with Basi and the topics he covers in the Financial, Legal & Tax Advisory which may be read in various industry-specific trade publications.

A CASE STUDY CONTINUED:

Editor's Comment: Control and marketability discounts are typically used in valuation calculations. The court did not allow the taxpayer to reduce value for "capital gains" because the shareholder did not have enough influence in the company to affect a sale of the appreciated assets. Had the taxpayer had significant influence, the court could have allowed a reduction in value due to potential capital gains tax.

This case is somewhat of a challenge for taxpayers. Previous precedent allows reductions for capital gains reflective of potential taxes. This case is states that such capital gains tax discounts may be disallowed if the taxpayer is of non-significant influence to affect dissolution. Most closely-held companies do not have small minority shareholders and influence is never an issue.



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Points of Interest

- **Those holding industrial stocks, financial stocks, transportation, and energy stocks are reporting their portfolio values have been cut essentially in half.**
- **A stock that has been battered in value or has become worthless still contains value for those holding the stock. The value comes in the form of a tax deduction.**
- **Timing capital losses against gains is critical, otherwise you could potentially have unused losses for the rest of your life.**

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The Major Pitfalls in Selling A Business – No. 2 Not Understanding the Selling Process

Mike Ertel, CBI/ M&AMI/ CM&AA

Selling a business is something that most business owners will only attempt once in their career. With an estimated 70% - 90% of their total net worth tied up in their business, they can't afford to make a costly mistake, but their success in running their own business generally doesn't prepare them to handle one of the largest and most crucial financial transaction in their life.

This is the second in a series of articles exploring some of the common pitfalls in selling a business.

Major Pitfall No. 2 -- Not Understanding the Selling Process

Since most business owners only experience the selling process once, so it is understandable that they are not familiar with the number of steps involved; nor how to deal with the issues that frequently arise at each step. Not knowing how to deal with these issues -- and/or not having a trusted, professional, M&A Intermediary for advice and direction -- will put the seller at a severe disadvantage in negotiations and reduces the likelihood of ending up with the best deal possible.

Experienced M&A advisors can perform or contribute to a wide variety of tasks, which, when successfully executed, will maximize the seller's return on the sale. Such tasks include: deciding when, where, how and to whom to market the business, and how best to promote its potential; determining what price to ask, or deciding when to go to market without an asking price; screening prospective buyers; maintaining and ensuring confidentiality throughout the process; developing financing alternatives for the buyer; working with the seller's CPA, attorney and financial planner to assist in structuring the deal to minimize tax liability and maximize seller proceeds; and so on.

Business owners frequently realize the need for confidentiality, but have difficulty traveling the right path between not revealing anything at all and revealing too much too soon. Another common mistake is to assume that since a buyer has signed a non-disclosure agreement, it is now "safe" to reveal anything and everything the buyer may ask about. While all prospective buyers must sign a Non-Disclosure Agreement (NDA) before being provided even basic information about the business, and experienced M&A advisor will assist in determining early on which prospects are likely to be serious prospects and which are unlikely to ever make an offer, and limit the release of confidential information accordingly.

Even with a signed NDA from the buyer in hand, an experienced M&A advisor will stage the release of confidential information – such as interviews with key customers and managers, etc. -- until it becomes clearer that the buyer is committed to making an acceptable offer.

If you know of a business owner who's thinking of selling or buying a business and who might benefit from a free consultation with us, have them contact me at mikeertel@legacyadvisorsgroup.com

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Frequently Asked Questions…

Q: What is new concerning the tax laws in 2009?

A: While a blanket statement cannot be made, there are some notable changes for business owners and individuals: 1) The gift exemption amount raises from $12,000 per year, per person to $13,000 annually per year, per person; 2) The estate exemption rose from $2,000,000 to $3,500,000; 3) The IRA contribution limits have changed from $4000 in 2008 to $5000 in 2009; 4) The 5% capital gain tax rate on capital gains and dividends is reduced to zero.

Q: The company that I hold stock in recently announced a stock split. How do I pay taxes on such an occurrence?

A: A stock split does not result in income or an increase in wealth. It is therefore not a taxable event. A stock dividend, on the other hand, is taxable. If a company announces a stock dividend, the fair value of the stock distributed is taxable to the shareholder as it would be had it been cash.

Q: I am interested in purchasing rental property this year. What closing costs are deductible?

A: The only closing costs that are deductible are costs associated with real estate taxes and interest. Closing costs for transfer taxes, recording fees, surveys, et cetera are includible in the property's basis.