Legacy M&A ADVISORS LLC

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The One Million Dollar Question: Literally in Some Tax Scenarios
Part 1 of 2

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Introduction
Recently we've been writing a lot about valuing and exiting your business. Today we turn to what happens after you decide to sell your business and before signing the letter of intent. In the excitement of the process, one key hurdle is virtually lost until it is too late. The hurdle is that of the tax consequences at the various levels of government.
Generally, the tax consequences are as important as the selling price itself. What we frequently find is that the tax returns, both on the business and individual levels have not been seriously studied.

Within the course of our tenure at The Center, we have run into a situation where a broker brought a ready, willing, and able buyer to a seller of a laundromat. The seller and broker then viewed the tax consequences of the sale. The seller, upon realizing he would be upside down on the transaction due to the depreciation recapture, broker fees, recording fees, mortgage payoff, etc., the seller walked out of the deal. Not good and that is why we write today! We recommend that you get your tax consequences analyzed by a tax specialist well before making your exit.

When a corporate business is acquired, the transaction may be structured as a purchase of either the corporation's assets or the shareholder's stock. In a taxable transfer of a business generally the seller is concerned with the immediate tax burdens that result from the sale. The buyer is concerned with the future tax burdens associated with the acquisition of the new business. A dollar of current tax liability is more costly than a dollar of future tax liability because of the "time value of money."

Consequences of Asset Acquisition to Buyer
When a corporation sells its assets, the character of the seller's gains and losses is determined by the allocation of the purchase price among the transferred assets. The buyer's basis in each of the assets it acquires is also established by the allocation of the purchase price among the assets purchased. The purchase price includes the price paid for the assets plus any liabilities assumed and acquisition expenses. The allocation of the basis is critical to the buyer since it can offset future income and reduce future taxes.

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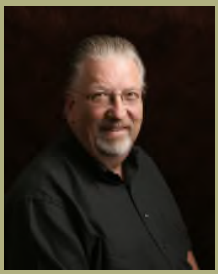

Mike Ertel is a Certified M & A Advisor and a Principal Broker with Legacy M&A Advisors, LLC, a full-service M & A Advisory firm with an office in Tampa, Florida specializing in representing sellers and buyers of small- to mid-sized companies. Prior to joining Legacy M&A Advisors, LLC, Mike's business career spanned 30+ years with Fortune 500 and Fortune 1000 Companies, with senior management roles in Marketing, Operations and Logistics. Mike also served as President, COO of a mid-sized Manufacturing company headquartered in Tampa. Mike also holds a BS in Electrical Engineering and an MS in Industrial Administration, both from Purdue.

A CASE STUDY

Bank Security Interest

The Seventh Court of Appeals has ruled that a lower court's decision resulting in the IRS having an inferior lean to a superior bank lean was incorrect. In the case, the property had a bank lien on it for "all rents" and sale proceeds. The borrower of the loan and owner of the property defaulted and the IRS filed a tax lien against the real estate. The tax appointed receiver then rented the property out for nearly six figures.

The Internal Revenue Code gives priority to a creditor's lien if the lien was proper and is in existence prior to the IRS claim. In this case, the rentals did not exist at the time the bank mortgage. Since the bank and lien was on the rents that did not exist, the lien was not valid until rents occurred; which was after the IRS stepped in. Accordingly the bank's lien was put in second place to the IRS.

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Cover Story

If the purchase price exceeds the fair value of the assets, the excess is known as goodwill. Goodwill is amortized over a fifteen-year period.

There are three basic benefits to the buyer of having an asset acquisition. First, the buyer can pick and choose which assets they want and leave behind such assets as obsolete inventory or those assets with liabilities attached. Second, because the buyer can eliminate certain liabilities, the transaction becomes less risky. Finally, as we mentioned earlier, the buyer will receive a stepped-up basis for appreciated fixed assets, which will allow them to depreciate and offset future income.

Consequences of a Stock Acquisition to Buyer

In a stock purchase, the buyer takes a cost basis in the stock equal to the purchase price. The assets and the corporation acquired become a wholly owned subsidiary. The problem here is the purchaser must take the same basis in the assets as they were with the seller as well as assume all of the selling company's debt. This has discouraged many transactions from being set up this way when there are highly appreciated assets being transferred or a lot of debt involved.

Within our Tax Code, we have what is known as the "IRC section 338 election," which allows the purchasing corporation to elect to treat the purchase of a target company's stock as an acquisition of its assets, resulting in a step-up in basis, meaning the purchaser can increase the basis in the assets to reflect the purchase price paid rather than taking a carryover basis. In order to obtain this treatment, the buyer must purchase at least 80% of the seller's stock and must make an election through filing proper IRS forms and pay the extra taxes.

A buyer that plans to make a IRC section 338 election normally will pay less for the target stock than for the target assets. When a IRC section 338 election is made, the selling company will recognize gain or loss on the deemed sale as if it were an actual sale of assets. The purchase price will be reduced by the amount the selling company will pay for taxes.

The decision to structure a purchase of a business as a stock or asset transfer many times will not be determined until negotiations with a seller have commenced. There are many variables that go into a decision; many stemming from the demands of the seller. Once again, Part 2 will be next month.

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About the author:

Roman A. Basi, President of The Center, is an Attorney, Real Estate Broker, and Title Insurance Agent. Roman speaks and advises The Center's clientele on such matters as Business Law, Succession, Estate & Tax Planning and Real Estate.

Points of Interest

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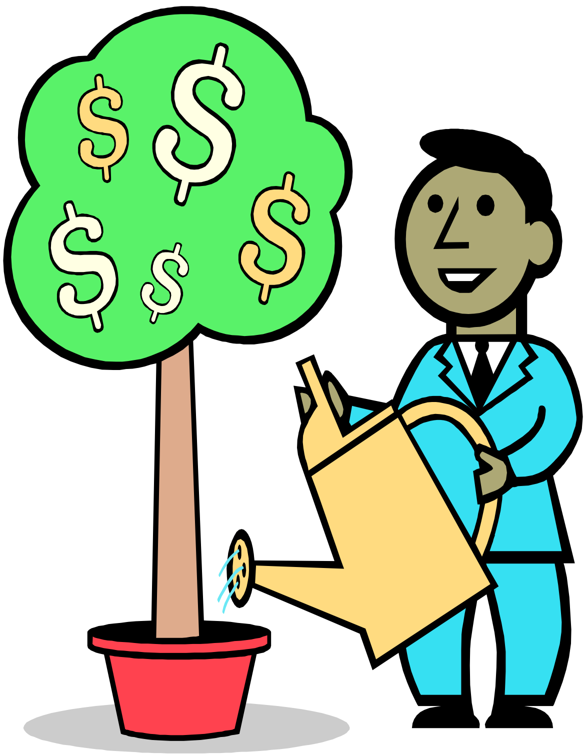
A CASE STUDY CONTINUED:

Editorial Comments:

Oftentimes, attorneys face confusion over which lien is superior when the IRS enters the matter. This case illustrates some of the complexity involved.
In this case, the individual actually won to some capacity. Had the IRS not been satisfied, the taxes would have stayed a liability to the taxpayer, resulting in a debt that could not be discharged in bankruptcy since the bank would have kept the rental income. Since the IRS won, the taxpayer was free to discharge the bank debt in bankruptcy. This is one time the taxpayer prayed that the IRS would win the case.



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Questions a Prospective Buyer Will Ask About Your Business

Regardless of the sweat equity you may have invested in building your business, when you put your business up for sale, a prospective buyer will value your business based on the expected value of its future cash flows.
You may work with a broker who will prepare a Confidential Business Review (CBR), which will highlight the various aspects of your business, and anticipate the buyers' most frequently asked questions. The goal of the CBR is to give the buyer sufficient insight into your business to decide that it meets their basic acquisition criteria and is worthy of further consideration. Your business won't be a good fit for every buyer, and may be worth more to some buyers than others.
A key question for most buyers is: Why do you want to sell your business? If your business is as profitable and successful as you say, why would you ever consider selling it? Buyers need to be assured that you are not trying to dump your business on an unsuspecting buyer to avoid impending doom. At the same time, they want some assurance that you are motivated to sell, and won't change your mind at the last minute after the buyer has invested a lot of time and money investigating your business and negotiating an offer.
Next, buyers will want to understand how you got into the business, how you've grown the business, how you see the business growing in the future, generally how you think about the business, its customers and its employees, and, truthfully, whether or not you're a reasonable and decent person. While buying a business may seem like a purely financial transaction, in reality it's more like a short term partnership between the new owner and the exiting owner, and if those personalities /values are not sufficiently compatible, the deal is not likely to succeed, regardless of how favorable the price and terms.
Finally, they want to talk about how a change in ownership will affect the business, its employees and its customers. The buyer's goal is to structure the deal and the ownership transition to maximize customer and employee retention, and minimize downside risk.
Here are sample questions buyers may ask:

- What would your ideal transition look like? What do you want to do post-sale?
- What is your day-to-day role in the business?
- Why do your customers buy from you rather than others?
- How long have your employees been with you, and why do they stay?
- Who are the future leaders in the company? What are their current and potential roles?
- How has the business evolved since you first got into it?
- What capital expenditures should be made in this business annually, and on what?
- What opportunities exist in this market through the next three, five, or 10 years?

When responding to a prospective buyer's questions, it's critical to be honest. Any dishonesty will ultimately be revealed in due diligence - if not sooner – and will cause the buyer to question what else you may have been dishonest about, and that growing doubt may ultimately undermine the entire deal.
On the other hand, if you honestly explain how the business works, you will likely find the right buyers present themselves, and you can exit your business on good terms.
If you would like to receive a copy of our white paper entitled: ***Value Drivers to Maximize the Value/ Selling Price of Your Business****, please contact me directly.*
As ever, if you know of a business owner who's thinking of selling or buying a business and who might benefit from a ***free, confidential****, consultation with us, have them contact me.*

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Frequently Asked Questions…

Q: What forms do we file to report a loss on the sale of a rental property?

A: Rental property is income-producing property and as such, considered business property. Report the loss on the sale of rental property on form 4797 Sales of Business Property. Normally, you transfer the loss as ordinary loss to line 14 of form1040, U.S. Individual Income Tax Return.

Q: I have heard that I can sell my rental property and use the proceeds to purchase rental property of equal or greater value and the transaction is viewed just like an exchange in that the tax is deferred until the new property is sold. Is this true?

A: Yes. What you have heard about is a transaction called a like-kind exchange. A like-kind exchange, when properly executed, can postpone the recognition of gain (and resulting current tax) essentially by shifting the basis of property sold to like-kind replacement property.

Q: I am renting a house to my son and daughter-in-law. Can I claim rental expenses?

A: In general, if you receive income from the rental of a dwelling unit, such as a house, apartment, or duplex, you can deduct certain expenses. There is no exception based on the relationship to those who live there.