EFFECTIVE TAX STRATEGIES IN THE SALE OF A BUSINESS

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Negotiating the best deal structure can have significant tax benefits in the sale of a business.

When it comes to selling their businesses, many owners are focused on the valuation multiples and selling price. They shrewdly negotiate the multiple paid, earnings base, projected financial results, and risk profile of the company, and discuss opportunities and threats to the business in a favorable light. These items are all important to getting a favorable deal. However, sellers should not stop at just negotiating a transaction price—they should also carefully work out the deal structure.

Ultimately, sellers' focus should be on how much after-tax cash they can put towards their future plans, and deal structure plays a key role towards this end. Between the price of the business and the cash retained at the end of the day are the taxes paid to the government. These taxes may vary significantly, based on how the deal is structured.

The tendency to focus on sale price rather than deal structure may occur because deal structure can be a confusing and intimidating topic. To make matters worse, the "right" deal structure may vary based on each individual owner's goals, objectives, and personal tax situation.

This article cannot provide exhaustive detail on all deal structures. It does provide a framework and strategies to help business sellers focus on after-tax cash proceeds. Keep in mind that every sale of a business is between three parties: the seller, the buyer, and the government.

While deal structure and taxes are not as exciting as negotiating business value, a little bit of attention can have a big payoff. In some deal structures, the buyer's and the seller's incentives may be misaligned. What is good for the buyer may not be good for the seller, and vice versa. Accordingly, it is important to understand these strategies to secure a favorable result for both parties.

Taxation: C corporations and pass-through entities

When selecting a deal structure, it is important to keep in mind how a business is structured for tax

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EXHIBIT 1 Strategies for Desired Outcomes

Desired Outcome	Strategy
Shifting reported sale proceeds from ordinary income to capital gains	Stock sale vs. asset sale (and accompanying purchase price allocation considerations)
Shifting sale proceeds out of C corporations	Sale of personal goodwill Deferred compensation
Delaying payment of taxes	Installment sale
Creating tax-efficient sale financing	Stock warrants Management incentive plans

purposes. Pass-through entities are generally taxed once, at the shareholder level. C corporations are taxed twice, at the entity level and the shareholder level.

At the federal level, pass-through entities such as S corporations and partnerships typically pay taxes only at the shareholder level, with a current top marginal rate of 37%, and not at the entity level. It is important to note that some states do not recognize pass-through entities, increasing the importance of having a tax specialist on one's deal team. Limited liability companies (LLCs) with more than one member are treated as a partnership by default, though they may have elected to be treated as a corporation.

C corporations pay a 21% federal tax rate plus applicable state and local income taxes at the entity level. On the shareholder level, profits are passed to business owners as dividends. Dividends are generally taxed as capital gains, at rates of 15% or 20%, and may also be subject to a 3.8% net investment income tax as well as state and local taxes.

One of the desired outcomes of the Tax Cuts and Jobs Act[1] was to have rough parity with respect to income tax rates between entity types. The addition of a Qualified Business Income deduction[2] helped achieve this goal, though there are limitations based on industry and income. This goal was met with respect to income taxes, but a C corporation may still face a heavier tax load with a sale.

Entity structure and deal structure can significantly impact the income taxes associated with the business sale. Taxes can generally be minimized by:

- Shifting sale proceeds out of C corporations because C corporations are subject to "double taxation" at the entity level and the shareholder level.
- Shifting reported sale proceeds from ordinary income (higher rates) to capital gains (lower rates).
- Delaying payment of taxes.
- Creating tax-efficient sale financing.

This article presents several strategies to meet these desired outcomes, as summarized in Exhibit 1.

Stock sale vs. asset sale

One of the primary decisions to make when selling a business is whether to structure the deal as a stock sale or an asset sale. In a stock sale, the buyer purchases the stock of the business, assuming all liabilities and responsibilities of ownership. In an asset sale, the buyer purchases the individual assets of the business (tangible assets as well as intangible assets such as customer lists and goodwill), which are then moved into a new ownership structure.

Selecting a stock sale or asset sale is not strictly a tax decision. Many buyers do not want the liability of stepping into the previous owners' shoes and being held responsible for any mistakes that were previously made. However, they may want certain contracts (leases, licenses, etc.) that cannot be transferred as eas-

[1] P.L. 115-97, 12/22/17.

[2] Section 199A.

[3] Associated Press, "Jordan Purchase of Bobcats Approved," *ESPN.com* (3/17/10). *http://www.espn.com/nba/news/story?id=5003048*.

[4] "NBA Team Valuations: #28 Charlotte Hornets," *Forbes.com* (February 2019). *https://www.forbes.com/teams/charlotte-hornets/#71a0f1b2364f*.

ily through an asset sale. These factors, as well as other considerations, should be kept in mind in addition to the tax implications discussed below.

In stock deals, the seller pays capital gains taxes (typically either 15% or 20% at the federal level) on the gain from the sale. Just like when selling stock on a stock exchange, the seller is taxed on the difference between the sale proceeds and the seller's cost basis of the stock. A shareholder's cost basis in C corporation stock is measured as what one previously paid for the stock plus any additional capital contributions. For pass-through entities, the cost basis of the stock is generally measured as the price previously paid for the stock plus accumulated earnings, less any losses or distributions. While partnerships are typically treated as pass-through entities, the tax and distribution implications are governed by the partnership agreement and are beyond the scope of this discussion.

Example: Consider the capital gains if former NBA superstar Michael Jordan sold his majority ownership position in the Charlotte Hornets through a stock sale. After being a minority investor since 2006, in 2010 Michael Jordan became the majority owner of the Hornets (then known as the Charlotte Bobcats) with a $275 million bid.[3] In 2019, Forbes estimated the Charlotte Hornets to be worth $1.3 billion, a healthy appreciation in value.[4] If Michael Jordan sold his equity for $1 billion, and if his cost basis was $300 million, he would pay capital gains taxes on the $700 million gain.

In asset deals, sellers are taxed on each individual asset that is sold. The parties negotiate a purchase price allocation for asset deals, assigning the total purchase price to the individual assets. Buyers and sellers have different motivations regarding purchase price allocation. Sellers generally want to push as much of the purchase price as possible to assets that will generate capital gains rather than ordinary income, which typically has a higher tax rate. Buyers usually want to allocate as much of the purchase price as possible to assets that they can depreciate or amortize quickly, providing an immediate tax benefit.

For asset sales, the C corporation sells all of its assets and pays corporate-level taxes on the gain. Typically, net proceeds are then distributed to shareholders in a liquidation. The proceeds distributed are compared to the shareholders' stock basis and taxed at capital gains rates.

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In asset sales involving S corporations, generally no taxes are paid at the entity level. Asset sales are passed through to the shareholder and taxed as capital gains or ordinary income depending on the nature of the assets sold.

If a depreciated asset is sold for a gain, the ordinary income tax rate will be applied on the amount of the recaptured depreciation expense. Gains on sale of land, a non-depreciable asset, would typically generate Section 1231 gains and possibly taxed as capital gains. Gains on depreciable real estate generate Section 1250 gains and can be taxed at the unrecaptured gains rate of 25%. Goodwill, non-compete agreements, and other intangible assets are amortized over 15 years as Section 197 intangible assets.

Sale of personal goodwill

The sale of personal goodwill is a strategy commonly employed to shift proceeds out of either (1) a C corporation or (2) an S corporation that still would be treated as a C corporation upon sale. Using this strategy, total consideration is divided into a price for the business assets or stock and a price for the sale of personal goodwill.

The Corporate Finance Institute defines personal goodwill as "the intangible value that arises from the efforts or reputation of a business owner or other individual."[5] If a significant component of business value is associated with an owner, it may be advantageous to purchase the personal goodwill directly from the owner in a separate transaction accompanying the sale of the business assets or stock.

The IRS looks closely at the sale of personal goodwill in conjunction with the sale of a business. The facts and circumstances of each particular situation determine whether the goodwill is associated with the person or the business. In order to successfully demonstrate that personal goodwill exists, two important areas must be addressed.

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First, personal goodwill must exist separately from corporate goodwill. Personal goodwill must be dependent on the business owner's characteristics such as the owner's relationships with customers, personality traits, expertise, and other factors. Second, personal goodwill must be separate from the business's assets, and the business owner must have the right to sell the goodwill. If a noncompete contract or employment agreement is in place, often it is assumed the business owns the goodwill.

If a portion of the sale proceeds can be allocated to personal goodwill, that portion of the income is recognized at the individual level rather than at the entity level. That income is then subject to long-term capital gains rates.

Example: The classic example involves, of all things, ice cream. Arnold Strassberg started an ice cream distributorship and entered into a handshake agreement with a new player in the frozen dairy aisle, Häagen-Dazs. Mr. Strassberg quickly converted supermarket relationships that helped establish the Häagen-Dazs brand. When Pillsbury bought that brand, it was interested in Mr. Strassberg's business connections, but not his business. *Martin Ice Cream Co*[6] has the rest of the story. Since that 1998 Tax Court decision, many business owners have sold a portion of their personal goodwill along with the underlying company.

Deferred compensation

Deferred compensation agreements are another way to siphon off a portion of the total consideration for a business into a different tax structure. In a deferred compensation agreement, the acquirer makes deferred compensation payments to the seller of the business in the periods following the business sale. Deferred compensation agreements are typically transferable if the seller dies.

The buyer benefits because the buyer can deduct deferred compensation as a business expense going forward. However, the seller reports ordinary income rather than capital gains income for the deferred compensation, which likely results in a higher tax rate.

Deferred compensation plans work best for transfer to family or trusted management members because deferred compensation agreements typically bind the buyer and seller together over a longer period of time.

Example: Bryant Stibel & Company ("Bryant Stibel") was co-founded by NBA superstar Kobe Bryant and entrepreneur Jeff Stibel in 2013. Bryant Stibel provides strategic, financial, and operational support to businesses, many of which are sports-related.[7] Should Mr. Stibel want to buy out Mr. Bryant, and assuming Mr. Bryant still has a significant endorsement income stream, a deferred compensation arrangement might benefit both. This arrangement would reduce Mr. Bryant's current income tax liability and provide an additional benefit pool to be tapped in the future. Meanwhile, Bryant Stibel may still be deducting the expense, reducing the tax liability at the entity level.

Installment sale

An installment sale (i.e., "seller financing") is a strategy used to spread out payments and taxes over a longer period of time. Installment sales work best in conjunction with a stock sale. Installment sales can benefit both the buyer and the seller. Buyers do not need to fund the entire pay-

[5] "Personal Goodwill," *Corporate Finance Institute. https://corporatefinanceinstitute.com/resources/careers/soft-skills/personal-goodwill/.*

[6] *Martin Ice Cream*, 110 TC 189 (1998).

[7] "About Bryant Stibel," *Bryant Stibel & Company. http://www.bryantstibel.com/about/.*

ment upfront and can instead use cash flow from the business to make installment payments.

In an asset sale, one still pays tax on ordinary income and depreciation recapture upfront, so it is important to structure the sale to allow enough cash to cover the associated tax liabilities. In a stock sale, the seller does not have to pay taxes until receiving installments. The seller still retains some risk in an installment sale as the buyer may default on payments. Installment sales are most effective for S corporations, which have one level of taxation.

Gains on the sale are reported and taxes due based on the proportion of the installment to the total purchase price.

Example: Consider if former NBA player Ulysses Lee "Junior" Bridgemann sold some of the 160 Wendy's restaurant franchises that he owns through a stock sale. Through ownership of Wendy's restaurants and other businesses, Bridgemann turned his modest NBA career earnings from the 1970s and 1980s (the most he ever made in a year was $350,000) into a net worth of over $400 million.[8] If Bridgemann decided to sell several of his Wendy's restaurants to a trusted employee who could not afford to pay the price outright, they may consider an installment sale. If the price for the restaurants was $10 million with a $5 million cost basis, Bridgemann would have a gain of $5 million, or 50% of the sale proceeds. If he received annual installments of $1 million, he would be taxed on a gain of $500,000 each year, equal to 50% of the $1 million installment.

Stock warrants

Stock warrants can be issued in conjunction with installment sales. A warrant is a right issued by a company to buy the company's stock on a specific date for a specific price. They are typically used to provide cash to a company in the short-term while giving the buyer rights to equity appreciation.

Warrants also are often attached to seller financing. Seller financing can feature below-market interest rates and favorable terms, so warrants are attached to compensate the seller. This reduced interest expense improves cash flow for the company, allowing warrant holders to participate in the growth in equity value. Because warrants are attached to the financing of a deal, they are subject to capital gains tax rather than ordinary income tax, producing a lower tax consequence than synthetic equity.

Management incentive plans

Using management incentive plans (i.e., synthetic equity) is another strategy that may be employed if buyers cannot afford the purchase price up front. Management incentive plans are often used to fund the sale of a business to members of management who otherwise would be monetarily constrained. Management incentive plans compensate management for increases in share price over a period of time. If the value of the company increases, management will receive a payout. This payout can then be used to fund a portion of the acquisition price, with the remainder funded either through bank or seller financing.

Management incentive plans are not very tax efficient, as the recipient is taxed on the compensation received, and then has to purchase stock using after-tax proceeds.

Conclusion

In a business sale, business owners often spend more time and effort negotiating the purchase price than the deal structure, which determines the amount of taxes paid. Deal structure can make a big difference on the amount of taxes paid and the amount of cash one gets to put in the bank at the end of the day. These strategies can save a lot of money. Buyers and sellers frequently benefit from different deal structures, so be prepared with a firm understanding of these topics to negotiate a favorable deal structure. ■

[8] Lechette Walker, "How A Former NBA Player Turned $350,000 into $400 Million," *Money Maven* (7/28/17). *https://moneymaven.io/blackwealthchannel/investing/how-a-former-nba-player-turned-350-000-into-400-million-FyRtXUpz5E6XFmVi6NhedA/*