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ACCOUNTANTS AND ADVISORS

Tax Planning Strategies for Selling Your Business – Part 2

Maximizing Your Wealth and Minimizing Your Tax Burden

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One of the best ways to increase and preserve your family's wealth when considering selling your business is smart tax planning. Often, taxes tend to be one of the most important strategies and negotiating points during the sale discussions. With U.S. tax rates potentially on the rise, sound tax planning now can help you structure and manage your ownership stakes in a way that increases your after-tax proceeds when you sell your business.

Consider the techniques presented in this article to maximize your wealth and minimize your taxes.

Tax Scenarios on the Sale of a Business

One of the most important dichotomies is ordinary income versus capital gains.

Ordinary income is often referred to as "earned income." Examples of ordinary income include salaries and wages and pension distributions, but ordinary income also includes "passive income," e.g., interest, non-qualified dividends, rent, and short-term capital gains royalties, etc. Ordinary income is taxed at "ordinary income" tax rates. Currently in the United States, there are seven federal tax brackets ranging from 10% to 37%. Additionally, certain taxpayers are subject to net investment income tax of 3.8% if they have investment income that exceeds certain thresholds.

Capital gain income is income that is realized from the disposition of a "capital asset," e.g., stocks, bonds, partnership interests and certain other types of property. Net long-term capital gains (generally gains realized on assets held for more than one year) are taxed at the preferential tax rates as compared to ordinary income. Long-term capital gains tax rates are taxed at 0%, 15% and 20% depending on taxpayer's income. The above-mentioned net investment income tax of 3.8% is also layered on top of these rates if the taxpayer's taxable income exceeds certain thresholds. Net short-term capital gains are taxed at the same rates as ordinary income.

Capital gains and losses are calculated based on this general formula: sales proceeds minus your tax basis, subject to certain adjustments. If you started a business and sold your common stock for $1,000,000 and your tax basis was $100,000, your capital gain would equal $900,000 [$1,000,000 minus $100,000].

There are certain instances when a portion of the realized gain has to be categorized as ordinary income (a.k.a. ordinary income recapture) or taxed at the higher rate (25% in the case of certain recapture when selling real estate, or 28% when selling collectibles).

Tax Strategizing

One strategy that's relatively easy to implement is to close a sale transaction when your holding period exceeds one year plus one day. This relatively straightforward tactic, pushes your gains into long-term status and qualifies for the reduced long-term capital gains tax rates. One potential risk to this tactic is that delaying closing a sale transaction could expose you as the seller to unforeseen economic conditions. An unexpected downturn or "Black Swan" event could materially reduce the value of your business or kill a sale transaction. One such example is the impact of COVID-19 on certain businesses, especially, for example, hospitality, travel and lodging.

Another strategy is to harvest losses – in other words, sell securities or assets that would generate a capital loss. Taxpayers can offset capital losses against capital gains, which could reduce a seller's taxes.

An “installment sale,” which means structuring the sale of your company “in pieces,” can also be considered. For example, you and the buyer would agree on a purchase and sale price and the terms, including the payment schedule. Your Purchase & Sale Agreement would say that the buyer takes ownership of an agreed-upon percentage of your business over the next, perhaps, seven or ten years. With an installment sale, you spread your capital gain and therefore your tax bill over a number of years. Caution must be exercised when deciding whether to spread the gain over multiple years or include it in income in year one. Some of the deciding factors are potential future tax rates increases, future income levels, etc.

Tax Consequences of an Asset Sale versus Stock Sale

- ***Allocation of Sales Price in Asset Sale Deals.*** In the event a seller sells the company’s assets as compared to common stock, the company assigns a portion of the purchase price to each asset to be sold. Market practice is to value the company’s assets and assign a fair market value to each asset and then determine the gain or loss.

- ***Depreciation Recapture in Asset Deals.*** Recapture is covered above, but since recapture of tax depreciation is treated as ordinary income, this would reduce the amount of the purchase price that is eligible for capital gains treatment.

Conclusion

Thoughtful tax, trust and estate planning, as well as business succession strategies, provide the greatest opportunity to maximize legacy economic wealth for business owners and their families.

Contact Us

PKF O’Connor Davies can assist with tax planning, due diligence and valuation relating to selling your business, as well as provide any needed accounting, audit, tax compliance and advisory services.

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