Twenty Questions Answered in the Acquisition or Disposition of a Business

Strategies for Structuring Transactions and Business Entities

By Peter A. Karl III

1. What considerations are involved in an acquisition/disposition of a business?

Significant legal and tax issues are involved for both business buyers and sellers. This is best illustrated by the fact that a purchaser rarely wants to acquire an enterprise through an entity purchase (i.e., by purchasing the ownership interest in the entity, such as stock, directly from the seller). From a legal perspective, the acquired business would remain exposed to the subsequent claims of pre-acquisition creditors, even those unknown at the time. In contrast, an asset purchase permits a buyer to choose which specific assets will be purchased along with which, if any, of the known liabilities will be assumed.

A corporate stock acquisition also presents tax disadvantages: The purchase price becomes part of the tax basis of the stock purchased without the benefit of the consideration paid being allocated for depreciation or IRC section 179 purposes among the underlying assets to be held by the entity (unless an election under IRC section 338 is made by a corporate purchaser, as discussed in Question 13 below).

Sellers generally prefer a business (conducted in corporate form) that is being sold to structure the transaction as a entity disposition in order to—

- qualify the stock transfer for capital gains tax rate;
- offset the gain against any personal capital losses being carried forward;
- use installment sale treatment (if seller financing is involved), which can apply to the entire sale, unlike the asset version; and
- take advantage of IRC section 1244 ordinary loss treatment, which is limited to $50,000 per year for taxpayers filing singly ($100,000 for joint filers).

Irrespective of the form chosen, a prospective buyer should be required to execute a confidentiality/nondisclosure agreement to discourage misuse of proprietary information.

2. How is the lump-sum sales price of assets allocated for tax purposes?

Because the transfer of a business involves a mixed property transaction encompassing both tangible and intangible personalty (along with possibly realty), a lump-sum purchase price without a specific allocation among assets should never be used. Furthermore, IRC section 1060 requires both the seller and the buyer of business assets to file Form 8594 (Asset Acquisition Statement). As a practical matter, a completed version of this form can be incorporated as an exhibit to the purchase agreement to ensure that both parties are consistent in their tax reporting.

As reflected in *Exhibit 1*, there are seven asset classes under this methodology (known as the residual method of

price allocation), each with varied tax consequences to the seller and the buyer, as discussed below. Because the IRS generally respects the negotiations between an unrelated buyer and seller, there is some flexibility in the allocation of the assets encompassing business realty and personalty (note that a professional appraisal can be concurrently obtained if needed).

3. In a disposition of business assets, what is the significance of the various classifications to the seller?

From the perspective of the seller, the importance of asset allocation among capital assets, IRC section 1231 assets, and assets with ordinary income implications cannot be understated, as shown in *Exhibit 2*. If the seller is a C corporation, the significance of this is less because there is no individual capital gain rate to utilize.

4. What tax strategies are available for a seller to minimize the tax implications of a disposition?

If the seller is involved in an asset disposition, IRC section 1031 can apply to both the realty and most of the business personalty. For example, any allocation to inventory would be nonqualifying. While the rules under section 1031 would allow the business real estate to be reinvested in commercial or even investment realty (including vacant land with or without a "build/rehab to suit" feature), the regulations impose much tighter restrictions on the rollover of the 1031 proceeds allocable to the personalty. With regard to the latter, Revenue Procedure 87-56 and the North American Industrial Classification System (NAICS) classify personal property in various categories, which must then be matched within exchange groups (i.e., comparing what is being disposed versus what is being acquired). Intangible personal property, such as goodwill, is ineligible for IRC section 1031 treatment. Nevertheless, the IRS, in Private Letter Ruling 200035005, has shown some flexibility with regard to intangible personal property by permitting the proceeds allocable to a FCC radio license to be rolled over to a television license.

If the new business needs to be acquired before an existing one is disposed, a "Reverse Starker" exchange may be appropriate in either the "Exchange Last" or "Exchange First" format. An Exchange Last involves the taxpayer lending money to an Exchange Accommodation Titleholder (EAT) who uses the funds to acquire the replacement property, which will be held in the EAT's name until the taxpayer is ready to close on the property to be relinquished. The Exchange First also involves the taxpayer lending money to the EAT to purchase the replacement property; however, in this version, the EAT acquires and holds legal title to the taxpayer's property to be relinquished. The Exchange First is often used when new financing will be involved in the acquisition of the replacement assets, whereas the Exchange Last is often used when the taxpayer is uncertain about which specific property will be subsequently relinquished. (For further information, refer to the author's article "Twenty Questions Answered About Deferred Realty Exchanges Under IRC Section 1031," *The CPA Journal*, May 2003.)

5. What are the alternatives to IRC section 1031 for a business seller?

Regardless of whether a stock or an asset disposition is being undertaken, tax-saving opportunities exist. A charitable remainder trust (CRT) can be an alternative to IRC section 1031 for a business disposition or when installment sale treatment is not available (e.g., when personal property such as equipment is being sold). This strategy can provide a higher than normal income stream to the former business owner because the payments from the trust are based on the pre-tax disposition price received by the CRT (as the titleholder and contract vendor of the property), along with the fact that a portion of the income will initially be tax-sheltered because of the available charitable deduction. This write-off will be based on the value of the remainder interest (using the IRS actuarial tables) and is subject to the annual adjusted gross income limitations (the five-year carryover period applies). This strategy requires the CRT to be created and funded with the business prior to the execution of the sales agreement. Because this arrangement does not provide any benefit to the children after the death of the parents as income beneficiaries of the CRT, a life insurance trust (funded with a second-to-die term policy) known as a wealth replacement trust can be used to replace what is "lost" to charity as the remainder beneficiary of the CRT. The key factor is whether the parents can obtain a reasonably priced policy, from an insurance underwriting perspective. (For further information, see the author's article "Twenty Questions Answered About Trusts," *The CPA Journal*, September 1998.)

An installment sale is another alternative, particularly when the seller receives a down payment sufficient to cover the tax liability for the ordinary income recognized in the first year stemming from the portion of the sale related to the disposition of personalty (depreciation recapture), accounts receivable, and inventory. The benefit to the seller of "holding paper" that is executed by individual signature or the purchasing entity (with the principals as cosigners) is that the annual income received will be higher than if there had been a taxable sale and an investment of the after-tax proceeds into a certificate of

EXHIBIT 1
Classification of Certain Assets Under IRC Section 1060 (Form 8594)

Class I: Cash (checking and savings accounts)

Class II: Certificate of deposit and marketable securities

Class III: Accounts receivable

Class IV: Inventory (valued pursuant to Revenue Procedure 2003-51)

Class V: Tangible realty and personalty

Class VI: Certain IRC section 197 intangibles, such as customer lists, trademarks, franchises, and any portion of the price allocated to a covenant not to compete

Class VII: Goodwill, along with any asset not categorized within one of the other six classes

deposit (CD). The reason is that the interest rate negotiated between the parties is usually higher than that offered by most financial institutions and is earned on the pre-tax mortgage balance amortized over the length of the obligation. In essence, a IRC section 453 transaction is tantamount to the seller receiving a secured CD. The detriment to holding paper, however, is that the seller of a business remains, in many situations, as a quasi-partner whose future payments depend on the success of the new owner, particularly when the business being sold does not consist of any realty used as security.

As a result, consideration should be given to incorporating additional protections for the seller (in the supplemental role of a future creditor) in the sales agreement, as a third-party financial institution would require. This could include a credit report, the pledge of other collateral, the signature of the spouse or other party on the note, the receipt of periodic financial statements, and even designation as a beneficiary under a term life insurance policy. If the buyer proposes to pay cash (with or without bank financing), restructuring the transaction using a third-party institution as the initial recipient (and subsequent payor of the buyer's proceeds over time) will avoid actual and constructive receipt by the seller of the closing funds. This commercially available immediate annuity (which does not have any surrender value) will allow gain to be deferred under IRC section 453.

When corporate stock is transferred in an installment arrangement, consideration should be given to the stock being held in an attorney's escrow arrangement, because the public filings in an asset sale of a mortgage or UCC-9 for realty and personalty, respectively, are inapplicable.

One significant legal advantage for a buyer (and disadvantage for a seller) would be to use an offset provision within the debt instrument providing that future payments be remitted to an attorney's escrow account in the event that any of the preclosing representations by the seller are found to be inaccurate after the acquisition. Earnout arrangements whereby the amount ultimately paid is contingent on future financial performance protect a buyer.

IRC section 453 requires any installment obligation longer than six months to contain a provision for interest at the lower of 9% or the applicable federal rate (AFR; the author recommends www.pmstax.com/afr/index.shtml as a reference). In addition, the payment of interest is required on the tax being deferred for any obligation over $5 million.

A third alternative is the use of an employee stock ownership plan (ESOP), which not only provides a potential buyer for a corporate business, but also offers significant tax benefits to a seller (including an S corporation), such as the following:

- The sale of the business' shares to an ESOP will be tax-deferred if the proceeds are reinvested in certain publicly traded or closely held stocks and bonds.
- Contributing the corporation's stock to the ESOP will create a deduction based on its fair value and could result in a carryback loss and/or tax refund.

In contrast to the three alternatives discussed above, the tax benefits of a private annuity trust have been eliminated by a proposed regulation that would deny IRC section 453 treatment to an owner selling property, including corporate stock.

6. How does a seller report the gain from mixed-use realty?

Revenue Procedure 2005-14 addresses transactions with realty that has both personal and business use, whether the business is conducted in one structure or separate ones. The former is best illustrated

EXHIBIT 2
Allocation of Lump-Sum Asset Sale Price: Seller's Perspective

	Capital Asset*	Section 1231 Asset†	Ordinary Income/Loss§	Self-employment Income**
Real Property				
Land	X			
Land improvements		X		
Building		X		
Personal Property, Tangible				
Inventory			X	
Depreciable personalty		X		
Personal Property, Intangible				
Accounts receivable			X	
Goodwill		X		
Other Intangibles				
Consulting agreement			X	X
Covenant not to compete			X	
Franchise trademark, trade name		X		

Notes:
* Individuals: Gains are taxed at the 15% rate (0% if taxpayer is in the 5% or 10% bracket) provided the asset is held at least a year; net losses can be used to offset ordinary income up to $3,000, and any excess is carried over. Corporations: Gains are taxed as ordinary income with no current-year offset for net capital losses (a three-year carryback and five-year carryforward are applicable).
† Individuals: For depreciable realty, the capital gain rates will apply to any gain in excess of: (a) that attributable to accumulated depreciation to which the IRC section 1250 uncaptured gain rate of 25% applies (though taxpayers eligible for the 0% capital gain rate are not subject to this provision); (b) any IRC section 1250 depreciation recapture applies because accelerated depreciation is used (e.g., land improvements, with its 150% declining-balance methodology). For tangible and intangible personalty, IRC section 1245 recapture will apply to the extent of accumulated depreciation/amortization; the capital gain rate is available for any excess. IRC section 1231 losses are treated as ordinary income, and to the extent any have been taken in the last five years these will change the character of any section 1231 gain from capital to ordinary income.
§ Includes any capital gain or IRC section 1231 asset held for less than a year, or dealer property.
** An additional 15.30% or 2.9% tax is owed, depending on a taxpayer's other self-employment income.

by a home office within a personal residence, while the latter includes a working farm with a home on the land.

Assuming that a taxpayer has owned and used the real property as a personal residence for at least two of the last five years, Revenue Procedure 2005-14 allows for the IRC section 121 gain exclusion to be first used on the residential portion and then on the business segment within the same structure (other than the gain attributable to post–May 6, 1997, depreciation). On the other hand, if the home and business are contained in separate buildings on the land, the section 121 gain exclusion that is not used on the residence may not be applied against the business portion. When realty contains separate structures, in order to maximize the tax-free portion of the gain related to the residence, an appraisal documenting the value of the house and accompanying acreage (as compared to the business realty) should be considered.

In either case, any gain related to the business portion of the realty which is ineligible for the IRC section 121 exclusion may be deferred by using IRC section 1031. While Revenue Procedure 2005-14 does not outline the specifics of an exchange encompassing real property with both personal and business use, the need for a four-party deferred exchange format, utilizing a qualified intermediary, is highly recommended.

7. How does a seller benefit from intrafamily gifting prior to a sale?

Unless the kiddie tax applies to the unearned income of a child, the gifting of assets or stock could result in the 0% capital gains rate being used for that taxpayer's portion of what is being sold (if taxable income in 2008 is less than $32,550; $65,100 for joint filers). The Small Business Work Opportunity Act of 2007 expanded the application of the kiddie tax rules by increasing the age to any child age 18 as of the last day of the tax year and certain full-time students between the ages of 19 and 23 (i.e., having earned income less than one-half of his or her annual support). For individuals not affected by these limitations of the use of the lower capital gains rate, there is also the advantage that the IRC section 1250 unrecaptured gain rate of 25% (related to the accumulated depreciation that exists when business realty is disposed) is inapplicable.

8. What strategies can reduce taxes in a stock sale?

While the sale of stock held for at least a year guarantees long-term capital gain treatment for the seller, the tax-free reorganization provisions under IRC section 368 can defer taxation when corporate stock of the buyer is part of the consideration received. Under IRC section 368, the Type B format involves a stock-for-stock reorganization, with the acquiring corporation exchanging its shares for those held by the stockholders of a target. The transaction could also be structured as a reverse triangular merger, whereby the buyer forms a subsidiary which merges into the target corporation, with this entity surviving as a subsidiary of the acquirer. These two transactions will be taxable unless at least 80% of the stock of the target is acquired or the seller receives consideration that is not voting stock.

9. From a buyer's perspective, what tax strategy should be considered for personal property?

In the allocation of a lump-sum purchase price, a buyer would be interested in obtaining the fastest writeoffs, which means an allocation to the assets with the shortest life for depreciation purposes, as outlined in *Exhibit 3*. The downside is that state and local sales taxes might apply. If this is the case, one should determine whether any of the assets are exempt from sales tax (e.g., if used in the production or sale of future items that are sales-taxable). The IRC section 179 deduction, available for new or used business personalty, is $128,000 in 2008, providing the most immediate tax benefit to the purchaser.

10. What else should a buyer acquiring business realty consider?

Buyers should consider whether a cost segregation study will be beneficial. Cost segregation separates property into components, providing shorter depreciable lives for categories such as personal property or land improvements (with its 150% declining-balance depreciation). The disadvantage is that the buyer is subsequently exposed to IRC section 1245 recapture, or may need to roll over the nonrealty proceeds in a section 1031 exchange with replacement personalty that qualifies under the stricter

EXHIBIT 3
Allocation of Lump-Sum Asset Sale Price: Buyer's Perspective

	Write-off Period, in Years
Real Property	
Land	N/A
Land improvements	15
Building: Commercial	39
Residential rental	27.5
Personal Property, Tangible	
Inventory	Cost of goods sold
Depreciable assets*	Generally 5 or 7
Personal Property, Intangible	
Goodwill	15
Other Intangibles	
Consulting agreement	15†
Covenant not to compete	15†
Franchise, trademark, trade name	15

Notes:
* While also eligible for the IRC section 179 expense, this category will generally be subject to sales tax, unless an exemption applies (e.g., the personalty will be used in the production of sales-taxable items/services).
† Irrespective of period stipulated in the agreement for payment or compliance.

like-class standard (which is not applicable to realty).

From a legal perspective, one of the most important contract contingencies when real property is part of a business acquisition is environmental testing. A buyer may otherwise face liability emanating from the misdeeds of the predecessor owners.

If the seller does not own the business realty, the buyer (prior to signing, or as a contract contingency) must carefully review the lease for provisions that address assignability and the ability to renew, as well as any purchase option or right of first refusal in the agreement.

11. Is goodwill a favorable category in the allocation of an asset sale?

From the seller's perspective (other than a C corporation), any asset allocation to goodwill qualifies for capital gains treatment. To the extent that any accumulated amortization from intangible assets exists, IRC section 1245 recapture is applicable. The Energy Bill of 2005 closed a loophole in the law whereby a taxpayer needed only to acknowledge the section 1245 recapture stemming from the goodwill and could avoid recapture associated with other intangible asset categories. Now all of the intangibles must be lumped together in order to first recognize the ordinary income attributable to the accumulated amortization.

The buyer also benefits from the goodwill allocation because it is not subject to sales tax. To the extent that the value of any business realty included in the transaction can be reduced correspondingly, this will provide a shorter writeoff period (i.e., 15 years rather than 39), along with lower annual realty taxes.

Whether goodwill can be treated as an asset of the shareholders and not the corporation is addressed in cases such as *Martin Ice Cream v. Comm'r* (110 TC 189, 1998) and *Norwalk v. Comm'r* (TC Memo 1998-29). The relevant factors include the extent of the shareholder's personal relationships in developing and retaining business; in a sale, this is usually addressed via post-closing contractual involvement by the former owner, possibly encompassing payouts based on future sales or retention of existing business.

It should be noted that if a tax-deferred exchange is being contemplated for the realty and tangible personalty, any allocation of the business purchase price to goodwill is not eligible for an IRC section 1031 rollover.

12. When should a covenant not to compete be used?

The buyer of a business should always incorporate a covenant not to compete within the transfer documentation. Courts will generally respect this provision if the wording is reasonable in terms of duration and geography. For example, a buyer purchasing a local restaurant might restrict the seller from competing during a five-year period within a radius of 25 miles, whereas a larger business with a statewide clientele could have broader geographic restrictions. When reviewing these clauses, courts attempt to strike a balance between protecting the buyer's interest and not depriving the former owner of the right to earn a living. From a tax perspective, a deduction (amortized over 15 years) is created, while offering another opportunity to slightly reduce the future assessed value of any realty which may be part of the business acquisition.

Given that many businesses would benefit after an acquisition by the presence or cooperation of the former owner for a period of six to 12 months, a consulting arrangement between the parties should also be considered by the buyer (noting the ordinary income and self-employment tax implications for the seller).

Consequently, the use of a covenant not to compete, a consulting agreement, and even goodwill payable to the individual as discussed in Question 11 above can be used in structuring the payment package for a C corporation selling its assets. Reducing the allocation to the entity will limit the proceeds subject to double taxation.

13. What elections are available under IRC section 338?

The regular IRC section 338 election permits a corporate stock transfer to be treated as an asset acquisition by the buyer; however, the disadvantages of this election arguably outweigh the advantages. This election is available only to corporations as purchasers of at least 80% of the target corporation. There will be gain recognition by the target corporation (which does not have to be dissolved), resulting in its assets being stepped up to their fair market value because of the deemed sale. Because of the ensuing tax liability, this election makes more sense when the target has offsetting losses or tax-credit carry-forwards.

An election under 338(h)(10) is appropriate when the stock of the target is owned by another corporation, when S corporation stock is being acquired by another corporation, or when the target is a member of a consolidated group. Double taxation is avoided under this provision when the target is a C corporation, because of the tax-free liquidation concept under IRC section 332, which results in the sale of the target stock being disregarded although its assets are stepped up to fair market value.

14. In an asset purchase, what type of notification is required to creditors?

While the Uniform Commercial Code no longer requires notice to creditors in a bulk sale transfer of assets, the New York State Department of Taxation and Finance, for example, does require notice when a business having sales tax obligations is to be transferred. Form AU 196.10 must be filed with the NYS Sales Tax Department 20 days prior to settlement in order to obtain a clearance, without which the purchaser would be liable for any of the seller's sales tax arrearages.

15. If the purchase of a business includes realty, should it be segregated from other assets?

If real estate is involved, this should first be separated from the business operations in order to be individually owned or held in a LLC, depending upon whether there are tort liability concerns and adequate insurance is available. Single-owner LLCs can also be used with multiple owners, each holding title as co-tenants (as opposed to one multi-member LLC). This allows for each individual to have the option of either a taxable sale or an IRC section 1031 exchange when they go their separate ways. With regard to the business operation itself, this could be held in a separate entity to provide legal insulation to the realty in the event the enterprise is subsequently sued. For example, the operation of a restaurant and bar could have the business personalty owned by a corporation and the building being leased on a triple-net basis by the shareholder in his individual capacity (or his singly owned LLC). The tenant would also be required to undertake capital improvements, which are tax-free to the lessor, and this arrangement would provide FICA-free

income to the realty's owners.

Generally, the use of a C or S corporation for the holding of real property is ill-advised given the tax effects (i.e., potential double and single taxation, respectively, as discussed in the author's article "Twenty Questions Answered About the Selection of a Business Entity," *The CPA Journal*, August 1999).

16. When should a buyer use a C corporation to operate an acquired business?

Although the tax advantages of the C corporation have diminished over the years, in certain situations this form should still be considered. Note that the legal protection afforded a stockholder in a closely held corporation is diminished because:

- Absolutely no entity (including an LLC) can shield an owner from personal liability if he is the one who committed (or to whom is attributed) the tort/negligence.
- A creditor usually will require a personal guarantee with respect to liability for the entity's major contracts (e.g., a bank loan or lease).
- The IRS may consider an individual to be the responsible party for unremitted trust taxes (e.g., payroll withholdings or state sales tax).

If the business owner will be required to reinvest profits in the operations, a C corporation allows for income-splitting between the W-2 of the officer/shareholder, while retained earnings are taxed at the corporate level (i.e., the first $50,000 at 15% and the next $25,000 at 25%). In addition, IRC section 1202 provides a 50% gain exclusion upon the sale of up to $10 million of stock held for at least five years, which makes it an excellent vehicle for corporations involved in an active business (such as technology). Excluded corporations under this provision include those involved in service, farming, and tourist-related activities (e.g., hotels and restaurants).

Upon a subsequent sale of a business that has been operated as a C corporation, one of the following three outcomes is possible:

- No taxation, if an IRC section 368 reorganization is accomplished (i.e., Type A merger/consolidation, Type B stock for stock, or Type C stock for assets).
- Capital gains taxation, if a stock sale is involved.
- Double taxation, if structured as an asset disposition.

While an IRC section 368 reorganization is most common when a publicly traded company is the acquirer, the dispositions of closely held corporate businesses are more often structured as an asset sale because of the issues addressed in Question 1 above. Alternatively, a stock purchaser of a business would be advised to discount the purchase price for the eventual built-in gains.

If a business held by a C corporation might be sold in the future, the conversion of the entity to a S corporation should be investigated. Because IRC section 1374 imposes a C level double taxation for the preconversion gain during the succeeding 10-year period, an appraisal of the assets at the time of conversion is recommended to establish the postconversion appreciation, because this portion will avoid the two levels of taxation.

17. When should a buyer use an S corporation to operate an acquired business?

If the business being purchased has income stemming from business capital (and not merely from services being rendered), using an S corporation can be an alternative to the increasingly popular LLC. This is because S corporation dividends (after payment of reasonable compensation to shareholder-employees) will not be subject to Social Security taxes. Because it is a pass-through entity, an S corporation should also be considered when initial business losses are anticipated, in order to offset other income on an individual's Form 1040, or be used to split income associated with the enterprise's capital among family members not subject to the provisions for the taxation of a child's unearned income as discussed in Question 7 above.

If the business acquisition arrangement involves an S corporation being partially acquired by nonqualifying shareholders (such as a C corporation), the transaction could be restructured, with the S corporation contributing its assets to an LLC tax-free under IRC section 721 (subject to concerns by the transferor about the adjusted basis of the assets being exceeded by the associated liabilities). As a result of this restructuring, the members of the LLC would be the S and C corporations.

18. What legal considerations should be implemented when a purchaser has co-owners?

Irrespective of the type of entity in which the operations will be conducted, one of the most important legal considerations before commencing a business with others (even if related parties) is a buy-sell agreement that includes restrictions on the transfer or pledge of any ownership interest. This is essentially a "prenuptial arrangement" for a business marriage, which negotiations in the marital context usually require separate advisors. This may be a relevant consideration with respect to the representation of the various parties involved in the buy-sell agreement. This document should address issues such as the valuation and funding for any subsequent buyout, which could be structured as an entity redemption, a cross-purchase by the owners, or a hybrid of the two.

The methodology for the value could be based on a predetermined formula (as discussed in Question 19, below), or a binding determination by a third party. Rarely should a fixed value be used; ideally, the value should be adjusted annually by the principals. Similarly, the valuation should not be based solely on book value, because often this will not accurately reflect the current fair market value. A unique approach is the "push-pull" method, whereby the departing owner sets the value and the remaining owners can either accept this price or require the offerer to buy out the offeree. In any case, the agreement should specifically define its terms, using "income," for example, in the context of a formula using a multiplier of earnings.

The first funding source should be life insurance if the co-owners are insurable at standard rates; a whole life policy is preferred to term life because the former also provides liquidity (i.e., cash value) in the event of a nondeath withdrawal. It is also very important to distinguish between the policies issued by a stock company and a mutual company. The policy dividends (used to reduce future premiums) payable to mutual company policyholders significantly exceed that payable to stock life company policyholders. This is because the latter's profits must also be shared with stockholders whose ownership classification does not exist in the rarer mutual companies owned by policyholders. As confirmed by the major insurance rating reference sources (A.M. Best, Fitch, Moody's, and S&P), only two companies are available to the general public, New York Life and

Northwestern Mutual, which rated in the highest category in each of these four services, both of which are mutual companies. When insurance is being considered, a separate policy covering disability (which should be specifically defined in the buy-sell agreement) should be reviewed. To the extent the policy's cash value or face value is inadequate for a buyout during life or death, respectively, the agreement should specify provisions with respect to the financing between the parties (i.e., fixed or adjustable interest rate, balloon payment, and security).

As reviewed in the author's article "Twenty Questions Answered About Business and Family Asset Protection" (*The CPA Journal*, February 2000), if the co-owners are family members, a family limited partnership (FLP) might be used for the asset protection and potential transfer tax savings due to valuation discounts. In addition, the FLP is the only entity where the super-minority owners can have super-majority control (e.g., parents as 2% general partners and the children as 98% limited partners).

Instead of having a husband and wife as co-owners (each filing a separate Schedule C as a qualified joint venture arrangement as established by the Small Business Opportunity Act of 2007), one spouse could own the business assets and the other own the nonbusiness assets (see the author's article "Twenty Questions Answered in Business and Family Asset Protection," *The CPA Journal*, February 2000.) In addition to sheltering personal assets in the event of the business's failure (including a responsible party trust tax assessment), the splitting of the assets' title between the spouses will result in potential FICA savings.

This strategy is best illustrated by an operation conducted as a sole proprietorship (or single-member LLC). This business will realize a $204,000 net profit in 2008. This would result in $18,564 of FICA taxes for the sole owner, compared to $31,212 if the business were conducted by husband and wife as a partnership or LLC. There may be a reason to have the spouse as a bona fide employee (which wages are not subject to FUTA taxes), in order to ensure eligibility for the minimum Social Security benefits upon retirement (40 quarters of lifetime employment). In addition, fringe benefits, such as a written medical reimbursement plan, long-term care policy, or health insurance, would be available. By deducting the health insurance on the proprietor's schedule C instead of from AGI, self-employment taxes would be reduced.

19. What are the valuation methods for a closely held business?

While certain business enterprises are valued as a multiple of gross revenues, other businesses might be valued based upon their assets. This can be done by taking the fair market value of tangible assets and then determining if there are excess earnings that may be attributable to goodwill (pursuant to Revenue Ruling 68-609). A third valuation alternative, the capitalization method, uses the following formula:

$$\text{Value} = \frac{\text{Net Operating Income (NOI) or Net Cash Flow (NCF)}}{\text{Capitalization Rate}}$$

NOI (operating revenue minus related expenses) or NCF does not include any financing expense or depreciation. EBDITA (earnings before depreciation, interest, taxes, and amortization) can also be substituted in the numerator. If the calculations encompass multiple years of past business activity or future business projections, these can be weighted or discounted, respectively. Adjustments usually need to be made to owner's compensation by factoring in the labor of the departing business executive or key person; that is, what it would take to compensate someone else for that same work. In contrast, the owner might be receiving excess compensation or employee benefits that could be understating NOI or NCF. The capitalization rate generally ranges from 5% to 20%, depending on the riskiness of the business (i.e., the riskier the business, the higher the cap rate).

If corporate stock is being purchased, the price should be discounted for the subsequent double-taxation potential upon liquidation in the case of a C corporation, or the remaining 10-year period under the IRC section 1374 built-in gains tax for an S corporation.

20. What tax traps exist when the buyer and the seller are related?

When the parties in a business disposition and acquisition are related (the definition of the term varies in the IRC), as addressed below, the following tax concerns need to be considered:

- The fair market value of the transfers can be scrutinized by the IRS and be recast as part sale, part gift.
- If an IRC section 1031 exchange is involved, IRS Revenue Ruling 2002-83 disallows a qualified intermediary from using the impounded funds to acquire replacement realty that is owned by a party related to the exchangor. Such a disposition by the related party (who is "cashing out" with funds received from the qualified intermediary) is deemed a sale under IRC section 1031(f). In contrast, Private Letter Rulings 20044002 and 200616005 permitted a related-party exchange when both parties took advantage of IRC section 1031 using a qualified intermediary and each party was required to retain the replacement realty received for at least two years.
- The portion of the consideration allocated to depreciable realty or personalty will be deemed ordinary income.
- If property that had been sold in installments is resold again in the two years following the acquisition, the first seller will be required to realize the sale proceeds from the initial sale.
- If a corporate redemption of stock is involved because the owner's children are acquiring the business, a waiver should be filed stipulating that for the succeeding 10-year period the redeeming shareholders will not have any interest in the corporation other than as a landlord or creditor; that is, the children are prohibited from acting as an employee, officer, or board member. This will avoid the family stock attribution rules and ensure that the distributions are not deemed to be a dividend. Though the 15% capital gain rate applies in any event, there must be a complete termination by the stockholder in order to use the basis in the stock being redeemed as an offset against the proceeds. ❑

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