Selling a Family Business the Tax Smart Way

When the owners of a family business are ready to sell, there are numerous considerations. One of the most important is handling the sale in a tax-wise manner.

In most cases, the buyer wants to make a direct purchase of the business's assets — as opposed to buying all the ownership interests in the legal entity used to conduct the business. A direct asset purchase allows the buyer to "step up" the tax basis of the acquired assets to reflect the purchase price. That means bigger post-purchase tax write-offs for depreciation, amortization, cost of goods sold and so forth.

A specific set of federal income tax rules applies to these transactions. Sellers who plan ahead can minimize their tax bills. Those who don't often pay too much to Uncle Sam and their state tax collectors.

Ground Rules

When assets that constitute a business are sold, the IRS requires the seller and buyer to use a certain method to allocate the total sale price to the specific assets involved.

On the seller side, this allocation assigns the total sale price to specific items to allow the seller to calculate taxable gains and losses asset by asset. On the buyer side, the allocation establishes the buyer's tax basis in each acquired asset.

The following basic procedure is used by both seller and buyer to allocate the purchase-sale price for tax purposes:

Step 1. First, allocate the price dollar for dollar to any cash and CDs included in the deal. Next, allocate the remaining price to government securities, any other marketable securities and any foreign currency holdings — up to the fair market values.

Step 2. Allocate the price remaining after Step 1 to any receivables — up to fair market values.

Step 3: Allocate the price remaining after Step 2 to any inventory or other assets held primarily for sale to customers in the ordinary course of business — up to fair market values.

Special Family Business Issues

Business valuations encompass tangible assets such as real estate and equipment, as well as intangibles such as employee loyalty, manufacturing processes, your customer base, business reputation, patents and new technologies.

Other considerations: The involvement of the selling generation and the expertise of the buyers. Many family businesses are built on successful relationships. The better these bonds can be maintained, the better the potential for continued success — an important factor if some relatives are staying with the business. For example:

- Customers may have more of a relationship with the selling owner than with the business itself. If that's the case, the business could be valued at a lower price due to possible customer turnover.
- The selling owner may have personal financial relationships that sustain the credit of the business. The owner may also have strong ties with staff members that could disappear under new management.

Step 4. Allocate the price remaining after Step 3 to generic business assets, including "hard assets" such as equipment, furniture and fixtures, buildings and land. The amount allocated to each asset must be proportional to the asset's fair market value, but not in excess of that amount.

Step 5. Allocate any price remaining after Step 4 to amortizable intangible assets other than goodwill. This category generally includes purchased intangibles that can be amortized for federal income tax purposes over 15 years. The amount allocated to each specific intangible asset must be proportional to the asset's fair market value, but not in excess of that amount.

Step 6. Any price remaining must be allocated to goodwill.

Insist on an Appraisal that Delivers Acceptable Tax Results

The allocation outlined above seems cut-and-dried. But it really isn't because the process of determining the fair market value of business assets is more of an art than a science. As a result, there can be two or more legitimate appraisals for the same business assets — and one may give you significantly better tax results.

Example: Let's assume you and the other shareholders of the family S corporation agree to sell the company's assets for $3,000,000. For the sake of simplicity, assume the assets consist of inventory, machinery, a building, land and goodwill. You want to *minimize* amounts allocated to inventory and machinery, because gains from those assets are passed thorough as "ordinary income" to you and other shareholders and taxed at regular rates of up to 37%.

On the other hand, you want to *maximize* amounts allocated to the land and goodwill because gains from those assets are taxed at no more than 20% (not counting the 3.8% Medicare surtax on net investment income that will be owed by some upper-income individuals). As for the building, gain up to the cumulative amount of depreciation deductions will be taxed at a maximum rate of only 25%. Any additional profit qualifies for the 20% long-term capital gains rate. So a relatively high allocation to the building is likely to be preferable to you and the other sellers.

The buyer hires a professional business appraiser to estimate specific fair market value figures for the assets included in the deal. Of course, the buyer has a tax incentive to *maximize* amounts allocated to inventory (which will be sold quickly), machinery (which can be depreciated over seven years) and goodwill (which can be amortized over 15 years). The buyer also has a tax incentive to *minimize* amounts allocated to the building (which must be depreciated over 39 years) and the land (which must be permanently capitalized for tax purposes). The appraiser comes up with the following fair market values:

Asset	Fair Market Value
Inventory	$500,000
Machinery	$800,000
Building	$650,000
Land	$400,000
Goodwill	$650,000
Total	**$3,000,000**

The buyer likes this appraisal because it allocates 65% of the purchase price to assets that can be written off relatively quickly (inventory, machinery and goodwill) and allocates only 13% to the land. However, as the seller, you are disappointed, so you hire another professional business appraiser for a second opinion. This appraiser comes up with the following fair market values:

Asset	Fair Market Value
Inventory	$250,000
Machinery	$500,000
Building	$800,000
Land	$800,000
Goodwill	$650,000
Total	**$3,000,000**

You're satisfied with the second business appraisal because it assigns 75% of the sale price to the building, land and goodwill, which are all low-taxed capital gain assets. By doing so, the second appraisal delivers much better tax results for you and the other sellers. So the next step is to negotiate a set of appraised values that deliver tax results you and the buyer can live with. There are bound to be differences, but once you have those valuations you can use them to allocate the purchase-sale price according to the six-step procedure explained above.

Remember: The appraisal work and any negotiations regarding appraised values should occur ***before*** the terms of sale are finalized. In coordination with your tax advisor, Gryphon Valuation Consultants can provide valuable input and assist in the determination of a tax-smart sale of assets for your family business. Contact us at (702) 870-8258 for a consultation

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