



What are the tax implications of buying or selling a business?

Merger and acquisition activity in many industries slowed during 2020 due to COVID-19. But analysts expect it to improve in 2021 as the country comes out of the pandemic. If you are considering buying or selling another business, it's important to understand the tax implications.

Two ways to arrange a deal

Under current tax law, a transaction can basically be structured in two ways:

1. Stock (or ownership interest). A buyer can directly purchase a seller's ownership interest if the target business is operated as a C or S corporation, a partnership, or a limited liability company (LLC) that's treated as a partnership for tax purposes.

The current 21% corporate federal income tax rate makes buying the stock of a C corporation somewhat more attractive. Reasons: The corporation will pay less tax and generate more after-tax income. Plus, any built-in gains from appreciated corporate assets will be taxed at a lower rate when they're eventually sold.

The current law's reduced individual federal tax rates have also made ownership interests in S corporations, partnerships and LLCs more attractive. Reason: The passed-through income from these entities also is taxed at lower rates on a buyer's personal tax return. However, current individual rate cuts are scheduled to expire at the end of 2025, and, depending on actions taken in Washington, they could be eliminated earlier.

Keep in mind that President Biden has proposed increasing the tax rate on corporations to 28%. He has also proposed increasing the top individual income tax rate from 37% to 39.6%. With Democrats

in control of the White House and Congress, business and individual tax changes are likely in the next year or two.

2. Assets. A buyer can also purchase the assets of a business. This may happen if a buyer only wants specific assets or product lines. And it's the only option if the target business is a sole proprietorship or a single-member LLC that's treated as a sole proprietorship for tax purposes.

Preferences of buyers

For several reasons, buyers usually prefer to buy assets rather than ownership interests. In general, a buyer's primary goal is to generate enough cash flow from an acquired business to pay any acquisition debt and provide an acceptable return on the investment. Therefore, buyers are concerned about limiting exposure to undisclosed and unknown liabilities and minimizing taxes after a transaction closes.

A buyer can step up (increase) the tax basis of purchased assets to reflect the purchase price. Stepped-up basis lowers taxable gains when certain assets, such as receivables and inventory, are sold or converted into cash. It also increases depreciation and amortization deductions for qualifying assets.

Preferences of sellers

In general, sellers prefer stock sales for tax and nontax reasons. One of their objectives is to minimize the tax bill from a sale. That can usually be achieved by selling their ownership interests in a business (corporate stock or partnership or LLC interests) as opposed to selling assets

With a sale of stock or other ownership interest, liabilities generally transfer to the buyer and any gain on sale is generally treated as lower-taxed long-term capital gain (assuming the ownership interest has been held for more than one year).

Obtain professional advice

Be aware that other issues, such as employee benefits, can also cause tax issues in M&A transactions. Buying or selling a business may be the largest transaction you'll ever make, so it's important to seek professional assistance. After a transaction is complete, it may be too late to get the best tax results. Contact us about how to proceed.