AMAA Conference
Tax Impacts on Negotiating the Deal
Structuring, Unique Techniques & More

By: Christian W. Blees, CPA, CM&A
BiggsKofford, Colorado Springs, CO

Introduction

Everybody knows that taxes are generally the largest single expense the Seller will experience associated with the sale of his business. So, why is it that brokers, attorneys, and other M&A advisors fail to make better use of tax structuring as a part of the overall negotiations? Aside from estimating the tax burden of the sale, perhaps they believe taxes are just something that must be dealt with after the deal is done. They are, like death, after all, unavoidable. Right?

Or not.

In reality, taxes are a negotiating variable that should be used in helping bridge the valuation gap between Buyers and Seller. But, to do this well you need a combined knowledge of the financial AND tax aspects of the M&A process, mixed with a little creativity. So, either brush-up on your tax skills, or find a good tax advisor who can help you come up with ideas.

Basics

Whether you are representing the Buyer or Seller in a transaction, you must first remind yourself that the Seller is not looking to get the highest price for their business. They are looking to create the highest amount of after-tax funds.

Seller – If you can help reduce the tax burden to the Seller, you can either help bridge the valuation gap and make a deal happen. Or, just allow the Seller to keep more of the sales price.

Buyer – If you can help the Seller walk away with the same amount of money through reduction of taxes, you might be able to bridge the valuation gap for the Buyer (i.e. reduce the price).

Note: Buyers should know and understand the Seller's tax situation, and should learn techniques to help reduce the Seller's tax (for their own benefit).

Structuring Techniques

We'll identify some of the issues and structuring techniques for the following situations:

1. Flow-through Seller (S-Corporation or LLC)
    a. Allocation of price techniques
    b. Installment reporting techniques
2. C-Corporation Seller
    a. Allocation to personal items.
    b. S-Election technique

Flow-through Seller (S-Corporation or LLC)

Traditional tax planning for flow-through entities (S-Corporations & LLC's) revolve around 2 issues:

1. Capital Gains vs. Ordinary Income (i.e. allocation issues)
2. Timing of income (i.e. deferral opportunities)

Price allocation techniques

Often allocation of price is an after-thought to be worked out a few days before closing by both parties' tax advisors. However, if properly used, it can actually be a negotiating tool for bridging the valuation gap.

The Seller wants most of the gain as Capital Gain – which generally means they want allocation to Goodwill items. And, they want to avoid ordinary income allocations – such as Consulting, Non-Compete, PP&E (above their basis).

The Buyer's tax advisors will generally tell them they want higher allocation for PP&E, which allows for quicker depreciation.

Allocation Item	Buyer's Treatment	Seller's Treatment
Inventory	Deduct as sold	Sold @ cost - no tax
FF&E	5 Year Depreciation (Plus Use Tax)	Ordinary (up to orginal cost)
Non-Compete	15 Year Depreciation	Ordinary Income
Training	Current Write-off	Ordinary (Plus Payroll taxes)
Goodwill	15 Year Depreciation	Capital Gain

So, the general thought is that there exists an equal balance between Buyer's and Seller's tax motivations, and therefore what will result is a non-tax motivated allocation.

However, there are a few problems with that traditional logic, which we will explore:

1. Most states have Use Tax charged to the buyer on tangible asset purchases – but not intangibles.
2. With capital gains rates now down to 15% vs. ordinary tax rates of 35%, the Seller’s tax savings far out-way the Buyer’s advantages.

Purchase Price Allocation Analysis
Using allocation to bridge the valuation gap

Seller	**Ordinary**	**Capital**
Price Allocation	100,000	100,000
Marginal tax rate	35%	15%
Tax	35,000	15,000
Difference	**20,000**	

Buyer	**5-Year**	**15-Year**
Price Allocation	100,000	100,000
Use Tax Rate	6%	n/a
Additional Use Tax	6,000	n/a
Total Cost	106,000	100,000
PV of Tax Savings (7%)	30,850	21,252
Less Use Tax	(6,000)	n/a
Present Value	24,850	21,252
Difference	**3,599**	
Ratio	5.56	

	Deductions		Tax Savings @ 35%	
	5-Year	**15-Year**	**5-Year**	**15-Year**
Year 1	21,200	6,667	7,420	2,333
Year 2	33,920	6,667	11,872	2,333
Year 3	20,352	6,667	7,123	2,333
Year 4	12,211	6,667	4,274	2,333
Year 5	12,211	6,667	4,274	2,333
Year 6	6,106	6,667	2,137	2,333
Year 7	-	6,667	-	2,333
Year 8	-	6,667	-	2,333
Year 9	-	6,667	-	2,333
Year 10	-	6,667	-	2,333
Year 11	-	6,667	-	2,333
Year 12	-	6,667	-	2,333
Year 13	-	6,667	-	2,333
Year 14	-	6,667	-	2,333
Year 15	-	6,667	-	2,333

Conclusion:
After considering the time value of deductions for the Buyer, the Sellers' tax savings for desiring capital gains exceeds the Buyer's desire for accelerated depreciation by nearly a 6:1 ratio. This "lop-sided" ratio could be used by the Buyer or Seller for their negotiating advantage.

Allocation Negotiation Examples

Example of Buyer Negotiation:

Original Allocation

Equipment	@ 35% tax	2,000,000
Goodwill	@ 15% tax	5,000,000
Total Purchase Price		7,000,000
After-tax for Seller		5,550,000

Revised allocation

Equipment	@ 35% tax	1,000,000
Goodwill	@ 15% tax	5,764,706
Total Purchase Price		6,764,706
After-tax for Seller		5,550,000

Reduction in Buyer's price paid	235,294
PV difference of Buyer's tax savings	(145,990)
Total Savings by Buyer	89,304

Example of Seller Negotiation:

Original Allocation

Equipment	@ 35% tax	2,000,000
Goodwill	@ 15% tax	5,000,000
Total Purchase Price		7,000,000
After-tax for Seller		5,550,000

Revised allocation

Equipment	@ 35% tax	1,000,000
Goodwill	@ 15% tax	6,000,000
Total Purchase Price		7,000,000
After-tax for Seller		5,750,000
Additional Cash to Seller		200,000
PV Cost to the Buyer		35,986

Tax Deferral Techniques

Tax deferral from a sale (or installment treatment) is generally obtained in one of two ways:

1. Promissory note (or hold-back) from the Buyer.
2. Escrowed funds from the sale (with substantial risk of forfeiture.)

With today's capital gains rates so low, many deferral techniques are becoming less attractive for a Seller to "volunteer" for. Especially when you consider the risks a Seller is taking for the privilege of deferral:

1. Risk of forfeiture or loss.
2. Risk of increased tax rates in future years.

**Note: If the Seller wants to "volunteer" for tax deferral with the sole purpose of saving taxes, you should make sure they understand their funds will be at much greater risk (to make the tax deferral valid), and therefore may not be worth the small tax savings from the deferral.

As a result of these risks, in today's tax environment the majority of installment treatment is merely making lemonade from the lemons a Buyer has "required" the Seller to take. But, whether the Seller is "required" to defer payment, or they have requested it, we can try to make the lemonade as sweet as possible. Here are 2 more aggressive ways to try and maximize the use of installment treatment:

1. Specific allocation of the installment contract.
2. State tax avoidance idea.

Specific Allocation of the installment contract

Generally a sale price allocation includes allocation to items with substantial basis (i.e. Equipment), and items with very little or no basis (i.e. goodwill). In addition, the price may be allocated between items that result in ordinary income (i.e. non-compete) vs. capital gains (goodwill). Therefore the benefit of deferring tax on some items is greater than others.

In contrast, the general method of allocating an installment agreement is to allocate across the entire sale based on total price (without regard to basis or nature of the tax rate).

Therefore, an ideal tax treatment would be for the assets with the greatest tax consequences (i.e. ordinary tax items or items with the least basis) to be sold on an installment note. And, the items with the least tax consequences (i.e. capital gains or high-basis items) should be sold for cash.

Installment Examples

Facts:

Sold business in 2005 with allocations shown below:

Installment Note / Escrow	2,000,000
Cash Paid	2,500,000
Total Sale Price	4,500,000

Normal Method

	Sale Price	Basis	Gain	Tax Rate	Tax	Installment Note Allocated	Cash Allocated
Equipment	1,000,000	700,000	300,000	35%	105,000	444,444	555,556
Non-Compete	500,000	-	500,000	35%	175,000	222,222	277,778
Goodwill	3,000,000	-	3,000,000	15%	450,000	1,333,333	1,666,667
Total	4,500,000	700,000	3,800,000		730,000	2,000,000	2,500,000

Installment Calculations	Cash Rec.	GP %	2005 Gain	Tax Rate	2005 Tax	Def. Gain	Def. Tax
Equipment	555,556	n/a	300,000	35%	105,000	-	-
Non-Compete	277,778	100.00%	277,778	35%	97,222	222,222	77,778
Goodwill	1,666,667	100.00%	1,666,667	15%	250,000	1,333,333	200,000
Total	2,500,000		2,244,444		452,222	1,555,556	277,778

Specific Allocations of the Note

	Sale Price	Basis	Gain	Tax Rate	Tax	Installment Note Allocated	Cash Allocated
Equipment	1,000,000	700,000	300,000	35%	105,000	-	1,000,000
Non-Compete	500,000	-	500,000	35%	175,000	500,000	-
Goodwill	3,000,000	-	3,000,000	15%	450,000	1,500,000	1,500,000
Total	4,500,000	700,000	3,800,000		730,000	2,000,000	2,500,000

Installment Calculations	Cash Rec.	GP %	2005 Gain	Tax Rate	2005 Tax	Def. Gain	Def. Tax
Equipment	1,000,000	30.00%	300,000	35%	105,000	-	-
Non-Compete	-	100.00%	-	35%	-	500,000	175,000
Goodwill	1,500,000	100.00%	1,500,000	15%	225,000	1,500,000	225,000
Total	2,500,000		1,800,000		330,000	2,000,000	400,000

Year-1 Taxes Saved	**122,222**

To build a defensible case for this installment allocation, the sale documents should support your position. Therefore, planning during preparations of the documents should be done. THIS IS NOT A GOOD RETROACTIVE TAX PLANNING METHOD.

1. This might be accomplished through separate contracts for the sale of cash items from the sale of the installment items.
2. Or, if one purchase agreement is used, the allocation of the installment note should be noted and explained in the document.
3. One example for justification of the allocation is to indicate the Seller’s note is being allocated to non-compete because of the Buyer’s ability to have the right of off-set specifically for the breach of the non-compete. In addition, the note agreement should reference the non-compete and goodwill as security for the note. You might also consider whether or not the Seller should make a security claim against the assets you’re claiming as sold for cash. (If the Seller’s note is secured by the equipment that was supposedly sold for cash, this could hurt your justification for the allocation.)

Possible State Tax Avoidance

If an acceptable installment note or escrow can be negotiated, or if an installment / escrow is a part of the deal anyway, perhaps the Seller should evaluate whether the following state tax avoidance technique is worth-while:

Lets assume Mary owns 100% of Big Mountain, Inc. (an S-Corporation with operations in Colorado.) The business has an offer to sell its assets on July 1 of 2005 for $20M (No debt assumption). The pre-sale balance sheet of the Company is as follows:

Inventory	$5,000,000
Fixed Assets	1,000,000
Total Assets	$6,000,000
Debt	$4,000,000
Equity	2,000,000
Total Debt & Equity	$6,000,000

Now assume the Seller and Buyer are able to negotiate acceptable terms for the purchase price to be paid as follows:

- Cash at closing $6M
- Promissory note due 1/10/06 $14M

Based on Section 453B, Big Mountain can liquidate during 2005 (prior to December 31) and distribute the installment agreement out to Mary while still retaining its deferred tax character. Therefore, the installment agreement will cause the recognition of the capital gain on Mary's individual return in 2006, when the note is paid.

Assume Mary moves and establishes residency in Florida for the year 2006, when the installment gain is triggered. Mary has no other Colorado source income in 2006, and therefore has no reportable reason to file a Colorado return. Florida has no state tax, while Colorado has a 5% tax rate.

With an extra $600k in tax savings, Mary is almost able to pay-off her 1BR condo in Miami Beach that she now calls home!!!

Installment Note for State Tax Avoidance

Cash Sale - 2005	Taxable Income	Cash Flow	
Sale Price	20,000,000	20,000,000	
Basis in Inventory	(5,000,000)	n/a	
Basis in Fixed Assets	(1,000,000)	n/a	
Debt paid-off	n/a	(4,000,000)	
Taxable Income	14,000,000		
State Tax Rate (CO Resident)	5%		
State Taxes Due (CO Resident)	(700,000)	(700,000)	
Federal Taxable	13,300,000		
Federal Tax Rate	15%		
Federal Taxes Due	(1,995,000)	(1,995,000)	
Net Cash Flow - 2005		**13,305,000**	
Installment Sale - 2005/2006			
2005 Sale Price Paid	6,000,000	6,000,000	(Note - Cash price allocated to Inventory and Fixed Assets only)
Basis in Inventory			
Basis in Inventory	(5,000,000)	n/a	
Basis in Fixed Assets	(1,000,000)	n/a	
Debt paid-off	n/a	(4,000,000)	
Taxable Income - 2005	-	n/a	
Cash flow - 2005		2,000,000	
2006 Installment Note Paid	14,000,000	14,000,000	(Note - Installment allocated 100% to Goodwill)
State Taxes Due (FL resident)	-	-	
Federal Tax Rate	15%		
Federal Taxes due	(2,100,000)	(2,100,000)	
Net Cash flow - 2006		11,900,000	
Net Cash Flow - 2005/2006		**13,900,000**	
Additional Cash Flow		**595,000**	

C-Corporation Tax Strategies

The major consideration with selling assets from a C-Corporation essentially boils down to avoiding the double tax. And, with the reduced capital gains and dividend rates, that can further be boiled down to avoiding or reducing the corporate level tax. We'll discuss three strategies for mitigating the corporate tax with a sale of a C-Corporation:

1. Stock sale negotiations.
2. Allocations to personal items.
3. S-Election games.
4. Stock buyer alternatives.

Stock Sale Alternative

If taxes were the only deciding factor, Sellers would more readily be able to negotiate the sale of their stock interest in lieu of assets in a C-Corporation with mathematical analysis of the issues. You can easily calculate the discount or premium necessary to equate a stock sale with an asset sale (depending which side you are representing).

Stock vs. Asset Analysis

From Seller's Perspective:

Stock Sale	**Tax**	**Cash**
Price for Stock (less debt payoff)	5,000,000	5,000,000
Corporate debt to pay-off	(500,000)	(500,000)
Basis in Stock	(100,000)	n/a
Gain / Sale proceeds	4,400,000	4,500,000
State Tax (5% rate)	(220,000)	(220,000)
Federal Tax (15%)	(660,000)	(660,000)
Net Proceeds to Seller		3,620,000

Equivalent Asset Sale	**Tax**	**Cash**
Corporate Asset Sale Price	7,379,585	7,379,585
Corporate debt to pay-off	n/a	(500,000)
Basis of Assets in Corp.	(1,000,000)	n/a
Corp Gain / Sale Proceeds	6,379,585	6,879,585
Corporate State Tax (5%)	(318,979)	(318,979)
Corporate Federal Taxable	6,060,606	6,560,606
Corporate Fed. Tax (34%)	(2,060,606)	(2,060,606)
Proceeds from liquidation	4,500,000	4,500,000
Stock Basis	(100,000)	n/a
Gain / Sale proceeds	4,400,000	4,500,000
State Tax (5% rate)	220,000	(220,000)
Federal Tax (15%)	660,000	(660,000)
Net Proceeds to Seller		3,620,000

From Buyer's Perspective:

	Asset Deal	Stock Deal	Difference
Price willing to pay	6,298,453	5,000,000	1,298,453
Basis for Depreciation (Allocation of Price):			
Inventory	500,000	500,000	n/a
PP&E	1,000,000	500,000	500,000
Goodwill	4,798,453	n/a	4,798,453
Total	6,298,453	1,000,000	

Additional Depreciation:	Addn'l PP&E Depreciation	Goodwill Amortization	Tax Savings @ 39%
Year 1	100,000	319,897	163,760
Year 2	160,000	319,897	187,160
Year 3	96,000	319,897	162,200
Year 4	57,600	319,897	147,224
Year 5	57,600	319,897	147,224
Year 6	28,800	319,897	135,992
Year 7		319,897	124,760
Year 8		319,897	124,760
Year 9		319,897	124,760
Year 10		319,897	124,760
Year 11		319,897	124,760
Year 12		319,897	124,760
Year 13		319,897	124,760
Year 14		319,897	124,760
Year 15		319,897	124,760
Present Value of Tax Savings	**1,298,453**		

Therefore, if a Buyer is willing to purchase stock, you should determine if the after-tax value to the seller would be greater than that of an asset deal, even by offering a discounted stock sale price. However, when evaluating the tax effect of an asset deal, you may want to explore some of the alternatives discussed below before agreeing to a discounted stock price.

If a Buyer is willing to consider a stock purchase and evaluate the price based purely on tax saving differences, then the math will generally be on the Seller's side. As you can see in the example below, a Seller looking to sell stock for $5,000,000 would ask nearly $7.4M to net the same amount in an asset deal. While the difference to a Buyer from a $5,000,000 stock deal vs. an asset deal is only $6.2M.

Unfortunately the world does not revolve around taxes and pure financial results. So, it is likely that the Buyer you are dealing with just plain refuses to purchase stock. There are, of course many financial and non-financial reasons not to buy stock:

1. No step-up in basis in the assets acquired.
2. Assumption of unknown liabilities.
3. Increased legal and accounting due diligence
4. Etc.

Allocation to Personal Items:

A creative and potentially aggressive alternative to selling pure assets of a C-Corporation is to split the purchase price between Corporate and Personal assets. This is generally done with allocations to one of three possible categories:

1. Consulting / Training
2. Non-Compete
3. Personal Goodwill

Personal Consulting Compensation:

Of these allocation alternatives, many people are most likely familiar and comfortable with allocations to Non-Compete and Consulting. In addition, these allocations categories have a lot of research, tax rulings, and "fair market value" studies that can be used to determine their allocation.

Example:

A Company's president / shareholder has historically been paid $150,000 per year in years leading up to the sale. As a part of the sale, the president is required to provide 6 months of training to the new owners and assist in the location of his replacement.

It might be reasonable to allocate a portion of the purchase price directly to the shareholder for these services. Unfortunately, the amount allocated will most likely be limited to a "reasonable" amount consistent with his historical salary level. (Perhaps 1.5 – 2 times his prior salary, due to the limited term and added responsibilities associated with his services.)

Certainly allocating $1M of the purchase price in this case for "Consulting" would be considered unreasonable. Although it helps, $200,000 to $300,000 out of a $10,000,000 sale price will hardly make much of an impact on the corporate tax bill.

More Compensation Ideas:

Along those same lines, the Company could try to justify a portion of the sale price be immediately paid after closing to the shareholder/officers for “deferred compensation”, if it could be justified that they were underpaid in prior years. This analysis should be backed up with compensation studies, and ideally supported with indications in the board minutes of the Company that the officers were consciously being underpaid.

Finally, a common reduction of Corporate taxes is the payment of severance pay or a “commission” paid to the officer / shareholder for their negotiation of a successful corporate sale.

Again, all of these ideas are going to be limited to some level of “reasonableness”. In addition, each of these ideas generates ordinary income to the shareholder, with payroll taxes due on top of that. So, the overall tax savings gained from these allocations may only be 6-7% compared to running it through the corporation, and paying the double-tax.

Non-Compete

Allocation to personal non-competes is nothing new, and certainly has been challenged in the courts on plenty of occasions. The IRS has accepted allocations directly to non-compete agreements with shareholders ranging from very little up to 90-95% of the deal.

So, what defines the allocation amount? Facts and circumstances.

In Revenue Ruling 77-403, the IRS indicates “the relevant factors include: (a) whether in the absence of the covenant the seller would desire to compete with the buyer; (b) the ability of the seller to compete effectively with the buyer in the activity in question; and (c) the feasibility, in view of the activity and market in question, of effective competition by the seller within the time and area specified in the covenant.”

Certainly, this definition is subject to interpretation and has been challenged a number of times. There are literally dozens of court cases debating this point on varying industries. Study of these cases and noting common themes is a good place to start to become comfortable with how aggressive you might get when advising a client to make use of this type of allocation.
Defensible

Personal Goodwill

An allocation of personal goodwill provides the “best-of-both-worlds” solution to the C-Corporation asset sale. It allows the Buyer to purchase assets and obtain basis in their purchase price for tax deductions. It allows the Seller to avoid corporate tax AND get long-term capital gain treatment. (Too good to be true??)

Although it is much less defined in the tax law, there is a hand-full of cases that acknowledge the existence of “personal goodwill”. Many of these cases relate to professional corporations (such as Doctors, Dentists, CPA’s, etc.). However, a recent and critical case (Martin Ice Cream) provides a reasonable platform to argue substantial personal goodwill in non-professional corporate industries.

Martin Ice Cream Case - 110 TC 189(1998):

> The facts of the case involved an ice cream distributor, who primarily distributed Häagen–Dazs Ice Cream. The shareholder (Arnold) built the wholesale business using both his personal relationships with the supermarket owners and his personal, handshake understanding with the Häagen-Dazs president. Arnold did not have any pre-existing non-compete agreement or employment contract with his corporation prior to the sale.
>
> In this case, the taxpayer (Arnold) allocated roughly $1,200,000 of an asset sale toward personal goodwill, while allocating about $300,000 to corporate goodwill of his company, Martin Ice Cream. The IRS argued that the total consideration received by Arnold and his Corporation should have been allocated entirely to the Company.
>
> In the case, the court ruled in favor of Arnold and indicated the more valuable asset was the intangible assets of Arnold’s rights and his relationships with the owners and managers of the supermarkets. The second, and much less valuable, was the business records that had been created by the corporation during Arnold’s development of the supermarket business.

Martin Ice Cream may provide guidance as to the allowable existence and allocation of personal goodwill from a corporate asset sale, but it falls short of providing reasonable justification for the allocation itself. And the case certainly doesn’t provide any formula or methodology for calculating the amount of personal goodwill apart from the corporate assets.

One possible approach suggested and used by a few CPA’s is to calculate personal goodwill by default. In other words, separately value all the assets of the corporation being sold (including identifiable corporate goodwill), and any purchase price above the identified corporate assets must be “personal goodwill”.

Another possible approach to valuation of personal goodwill might be using definitions found in non-tax courts. In many states, the concept of personal goodwill is readily discussed, accepted and used in the civil courts when dealing with valuation of business interests for purpose of marital dissolution. Therefore, one method to value personal goodwill might be to employ a valuation expert familiar with the methodologies used and accepted in the local divorce courts for defining the personal goodwill value.

Personal Allocations for C-Corporation Sale

Stock Sale

	Tax	Cash
Price for Stock (less debt payoff)	5,000,000	5,000,000
Corporate debt to pay-off	(500,000)	(500,000)
Basis in Stock	(100,000)	n/a
Gain / Sale proceeds	4,400,000	4,500,000
State Tax (5% rate)	(220,000)	(220,000)
Federal Tax (15%)	(660,000)	(660,000)
Net Proceeds to Seller		3,620,000
PV of Buyer's Lost Tax Savings	**990,729**	
Buyer's Equivilent Asset Price	**6,298,453**	

Seller's Equivalent Asset Sale - Traditional Allocation / Liquidation

	Tax	Cash
Corporate Asset Sale Price	7,379,585	7,379,585
Corporate debt to pay-off	n/a	(500,000)
Basis of Assets in Corp.	(1,000,000)	n/a
Corp Gain / Sale Proceeds	6,379,585	6,879,585
Corporate State Tax (5%)	(318,979)	(318,979)
Corporate Federal Taxable	6,060,606	6,560,606
Corporate Fed. Tax (34%)	(2,060,606)	(2,060,606)
Proceeds from liquidation	4,500,000	4,500,000
Stock Basis	(100,000)	n/a
Gain / Sale proceeds	4,400,000	4,500,000
State Tax (5% rate)	220,000	(220,000)
Federal Tax (15%)	660,000	(660,000)
Net Proceeds to Seller		3,620,000

Alternative Asset Sale - With Personal Allocations

Personal Non-Compete	500,000
Personal Consulting	150,000
Personal Goodwill	1,500,000
Corporate Assets	3,997,010
Alternative Asset Purchase Price	**6,147,010**

	Tax	Cash
Corporate Asset Sale Price	3,997,010	3,997,010
Corporate debt to pay-off	n/a	(500,000)
Def. Comp/Severence Bonus	(500,000)	(500,000)
Basis of Assets in Corp.	(1,000,000)	n/a
Corp Gain / Sale Proceeds	2,497,010	2,997,010
Corporate State Tax (5%)	(124,851)	(124,851)
Corporate Federal Taxable	2,372,160	2,872,160
Corporate Fed. Tax (34%)	(806,534)	(806,534)
Proceeds from liquidation	2,065,625	2,065,625
Stock Basis	(100,000)	n/a
Personal Goodwill Allocation	1,500,000	1,500,000
Capital Gain / Sale proceeds	3,465,625	3,565,625
Ordinary Income Items	1,150,000	1,150,000
State Tax (5% rate)	173,281	(173,281)
Federal Ordinary Tax (35%)	402,500	(402,500)
Federal Cap Gains Tax (15%)	519,844	(519,844)
Net Proceeds to Seller		3,620,000

Although these aggressive allocations are likely proposed by a Seller looking to save taxes, don't discount the ability of a Buyer to use these concepts to their advantage in bridging the valuation gap with a Seller. Often times the Seller is getting basic tax advice (or no advice), and they are likely to propose the standard stock vs. asset alternatives.

As noted in the example, the Seller's stock sale alternative will cause the Buyer to leave too many tax deductions on the table. And, the Seller's equivalent asset sale price is way out of the Buyer's comfort range. So, a creative structure involving personal allocations might be the compromise that meets everyone's expectations.

Making Good use of S-Elections:
When clients with C-Corporations first become aware of the potential double taxation they are going to experience with the sale of their business, one of the first suggestions they make is to become an S-Corporation. This is when you must try and explain the concept of Built-In-Gains (BIG) tax.

The idea behind BIG tax is to cause a C-Corporation to pay the corporate level tax regardless of their attempt to make an "S" election prior to a sale. The Code defines the built-in gain as the "excess of the fair market value of an asset at the beginning of the corporation's first taxable year as an S corporation over its adjusted basis at that time."

With this definition in mind, here are some of the opportunities that could be explored to take advantage of the S-Election concept:

1. "Fair market value" could be far less than sale value.
2. Use allocation to personal items to reduce FMV at S-Election.
3. Determine if your state has a BIG tax equivalent.
4. The concept of dissipating intangibles.

Define Fair Market Value:
The valuation experts in the room can tell us that a reasonable definition of FMV can yield a very different results from what actually sells. As a broker, we are always trying to yield the highest price for a Seller, which often times may create a higher value than FMV. So, if an S-Election can be made (even 6-months to a year) before the sale date. And, a solid valuation report can be prepared which identifies a lower FMV than the sale price, this could justify a far-reduced double taxation problem.

Use of Personal Allocations:
Normally, a corporation would be advised to have a valuation done coincident with its S-Election. However, if a sale is anticipated within a couple years, perhaps a slightly aggressive technique would be to defer valuation of the C-Corporation goodwill until after the sale. During the sale (as an S-Corporation), the Seller could use the personal allocation techniques noted above to drive-down the value of the Corporate assets. The de-valued corporate sale could then be used as "hind-sight" knowledge to prepare a valuation of those same assets 2-3 years earlier.

Avoid State Corporate Tax:
Although BIG tax is meant to equate the effect of a C-corporation sale, it is only a Federal tax provision. There are some states (such as Colorado) where no equivalent of BIG tax exists. Therefore, at a minimum the effect of corporate state tax is avoided, even if the S-Election were to be made just before the sale. No aggressive tricks, just a good old-fashion loophole in the state tax laws.

Asset Sale of C-Corporation

	Tax	Cash
Corporate Asset Sale Price	5,000,000	5,000,000
Basis of Assets in Corp.	(1,000,000)	n/a
Corp Gain / Sale Proceeds	4,000,000	5,000,000
Corporate State Tax (5%)	(200,000)	(200,000)
Corporate Federal Taxable	3,800,000	4,800,000
Corporate Fed. Tax (34%)	(1,292,000)	(1,292,000)
Proceeds from liquidation	3,508,000	3,508,000
Stock Basis	(500,000)	n/a
Gain / Sale proceeds	3,008,000	3,508,000
State Tax (5% rate)	150,400	(150,400)
Federal Tax (15%)	451,200	(451,200)
Net Proceeds to Seller		2,906,400

Asset Sale of Recent S-Corporation

	Tax	**Cash**
Corporate Asset Sale Price	5,000,000	5,000,000
Basis of Assets in Corp.	(1,000,000)	n/a
BIGain / Sale Proceeds	4,000,000	5,000,000
Corporate State Tax (5%)	n/a	n/a
Corporate Federal Taxable	4,000,000	5,000,000
Corporate BIG Tax (34%)	(1,360,000)	(1,360,000)
Proceeds from liquidation	3,640,000	3,640,000
Stock Basis	(500,000)	n/a
Gain / Sale proceeds	3,140,000	3,640,000
State Tax (5% rate)	157,000	(157,000)
Federal Tax (15%)	471,000	(471,000)
Net Proceeds to Seller		3,012,000
Additional Proceeds		**105,600**

Dissipating Intangibles:
The idea behind BIG tax is to capture the C-Corporation gain that existed in a particular asset. However, the Built-In-Gain cannot exceed the actual gain. In other words, if an asset with $0 basis was worth $100 when the S-Election was made, but sold for $70 three years later, the BIG is only $70.

Therefore, an aggressive approach to valuation could be to separate the “old goodwill” that existed on the conversion date from the “new goodwill” that was created after the conversion, but before the sale. If it can be justified, allocate the price separately for the sale of the “old goodwill” as compared to the “new goodwill”.

One specific example of this might be the sale of customer list "goodwill". Let's say the CPA firm was worth $5M on 1/1/00 when it converted to an S-Corporation, and the firm had 5 equal clients at the time (Client A, B, C, D, and E). The firm then sold 3 years later for $5M, when it had 5 clients (Client A, B, C, F, and G). So, during the S-years clients D and E were lost, and replace with clients F and G.

You could argue that the "old goodwill" that was sold for $3M ($1M per client). And, "new goodwill" was sold for $2M. Therefore, the BIG would only be $3M.

Appendix

Cases Discussing Non-Compete Allocations

Howard Pontiac-GMC Inc, (1997) TC Memo 1997-313 , RIA TC Memo ¶97313, 74 CCH TCM 45.

Crissey, Betty, (1961) TC Memo 1961-189 , PH TCM ¶61189, 20 CCH TCM 947.

Lutz, Eleanor, (1966) 45 TC 615 , revd on other issue (1968, CA9) 21 AFTR 2d 1425 , 396 F2d 412, 68-1 USTC ¶9423.

Herndon, James, (1962) TC Memo 1962-184 , PH TCM ¶62184, 21 CCH TCM 1013.

Heritage Auto Center Inc, (1996) TC Memo 1996-21 , RIA TC Memo ¶96021, 71 CCH TCM 1839.

International Multifoods Corp, (1997) 108 TC 25, later op (1997) 108 TC 579.

Thompson, Charles, (1997) TC Memo 1997-287 , RIA TC Memo ¶97287, 73 CCH TCM 3169.

Carey Advertising Inc, (1972) TC Memo 1972-124 , PH TCM ¶72124, 31 CCH TCM 497.

Radio Medford Inc v. U.S., (1957, DC OR) 51 AFTR 331 , 150 F Supp 641, 57-1 USTC ¶9570.

National Service Industries Inc v. U.S., (1973, DC GA) 32 AFTR 2d 73-5863, 379 F Supp 831, 73-2 USTC ¶9703.

Howard Constructions Inc, (1964) 43 TC 343 , acq 1965-2 CB 4.

Forward Communications Corp v. U.S., (1979, Ct Cl) 44 AFTR 2d 79-5917 , 221 Ct Cl 582 , 608 F2d 485 , 79-2 USTC ¶9638 .

Cases Discussing Personal Goodwill

Martin Ice Cream Co., (1998) 110 TC 189

Norwalk, William, (1998) TC Memo 1998-279

Staab, George J., (1953) 20 TC 834 , acq 1953-2 CB 6