§ 4 Tax Savings Structures and Strategies for Attorneys

§ 4.01 Introduction

This section reviews the various tax issues related to the acquisition and sale of a business. The taxation of the various forms of business entities is discussed. The tax consequences of business acquisitions and sales taking the form of asset and equity purchases are discussed in detail. A discussion of the methods available to allocate a lump-sum purchase price to individual assets that comprise a business is presented.

This section should be used only as a guide to identifying many of the complicated tax issues related to the acquisition and sale of a business. This section is not intended to be exhaustive and does not identify every tax issue that should be considered when advising clients in the purchase and sale of a business. Each taxpayer's particular situation should be analyzed and the advice of an experienced tax professional should be obtained.

§ 4.02 Tax Efficient Structures and Choice of Entity

[1] In General

A "C" corporation is a taxable entity separate from its owners. A "C" corporation can elect to be taxed as an S corporation. S corporations and partnerships are pass-through entities. This means that the entity is not subject to an entity level income tax and all items of income and deductions flow through to the tax returns of the owners.

Generally, losses from pass through entities can be used to offset other income of the owners. This may be beneficial if losses are anticipated in start-up years. The deductibility of losses allocated to inactive owners may be limited by the passive activity loss rules.

Limited liability companies (LLCs) do not have a separate tax scheme under the Internal Revenue Code. Generally, a single member LLC is taxed as a sole proprietorship and a multiple member LLC is taxed as a partnership. Under the so call "check the box regulations", LLCs can elect to be taxed as a C corporation or an S corporation.[1]

[2] C Corporations

Corporations are a separate taxable entity. C corporations pay an entity level federal tax of 21 percent. Distributions to shareholders are dividends. Dividends are taxable to the shareholders and not deductible by a corporation. This results in a double layer of tax.

Closely held corporations may avoid the double layer of tax if the shareholders are also employees of the Corporation. Instead of paying dividends, a corporation can distribute profits in the form of wages if the wages are not unreasonable in relation to the

---

[1] Reg. § 301.7701-3

Copyright © 2019 Rodger O. Howells, LLC

services performed by an employee/shareholder. There are no restrictions regarding the type of entities that can own stock in a C corporation.

The flat tax rate of 21 percent imposed on C corporations is lower than the individual tax rates imposed on higher income taxpayers. C corporations may be beneficial if owners want to reinvest profits into the business. The reinvested profits are not subject to a self-employment tax that would apply to individuals who are active partners in a partnership and to sole proprietorships.

[3] S Corporations

S corporations are generally not subject to an income tax at the corporate level. All items of income and deductions flow through to the shareholders in proportion to their stock ownership. S corporations may not make special allocations of income and deductions to certain investors.[2] This may hinder attracting investors to fund a startup venture or business acquisition.

S corporations may have no more than 100 shareholders and the shareholders must be individuals.[3] There is a two-year exception to the individual ownership rule when a shareholder dies; the deceased shareholder's stock can be held by an estate or trust for two years.

The shareholders are taxed on income regardless of whether or not the profits are distributed out to them. Cash distributions of earnings are not federally taxable to the shareholders; however, they may be subject to the New Hampshire Interest and Dividends Tax.

[4] Partnerships

Partnerships are not subject to a federal income tax at the entity level. Similar to S corporations, all items of income and deductions flow through to the owners of the partnership. Individuals who are active owners in a partnership are subject to a self-employment tax on partnership income. Cash distributions of profits are not taxed to the partners unless the distribution exceeds a partners' basis in the partnership interest.

The rules regarding the allocation of items of income and deduction are more flexible than S corporations. A partnership may allocate income and deductions to the owners in manner as long as the allocations have a business purpose (referred to as substantial economic effect).[4] This can assist in raising capital from outside investors while the partners remain in control of the entity.

---

[2] Reg. §1.1361-1(l)(1)
[3] IRC § 1361(b)(1)(A)
[4] Reg. §1.704-1(b)(2)(ii)(a)

Copyright © 2019 Rodger O. Howells, LLC

[5] Sole Proprietorships

The income derived from a sole proprietorship is included in the taxable income of the owner regardless of whether or not the owner distributes profits from the company. The income from a sole proprietorship is subject to a self-employment tax in addition to an income tax. Losses from a sole proprietorship may offset other income of the taxpayer.

[6] Qualified Business Income Deduction for Noncorporate Taxpayers

[a] In General

The Tax Cuts and Jobs Act[5] added IRC 199A. This section provides individuals a tax deduction equal to 20 percent of business income. Congress enacted this deduction to give individuals a reduction in taxes associated with business income that is similar to the reduction of corporate tax rates to a flat rate of 21 percent. The deduction is taken at the individual level but the deduction is also available for business income associated with income received from partnerships and S corporations.

The deduction effectively makes the maximum individual income tax rate on business income 29.6 percent (calculated as the maximum income tax rate of 37 percent x 80 percent). The deduction is not available against the self-employment tax.

Generally, the deduction is calculated as the lesser of 20 percent of qualified business income or 20 percent of taxable income excluding the portion of taxable income taxed at preferential rates. For higher income taxpayers the maximum deduction is limited by 1) the type of services performed by a business and 2) wages paid and the adjusted basis of property used by the business.

Qualified business income is generally derived from a trade or business. A trade or business for purposes of the section 199A deduction can include a rental real estate enterprise if the taxpayer performs at least 250 hours of services for the enterprise during the tax year.

[b] Higher Income Taxpayers

The qualified business income deduction for single taxpayers with taxable income of $157,500 or more and married filing joint taxpayers with taxable income of $315,000 or more is either phased out <u>or</u> is limited by wages paid and the unadjusted basis of property used in the business.

For specified service trades or businesses (SSTB), the qualified business income deduction is eliminated for single taxpayers with taxable income of $207,500 or more and for married filing joint taxpayers with taxable income of $415,000 or more. Specified service trades or businesses are businesses performing services in the fields of health,

---

[5] P.L. 115-97

Copyright © 2019 Rodger O. Howells, LLC

law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, investing, and trading and dealing securities.

For higher income taxpayers not deriving income from a SSTB, the qualified business income deduction is limited to the lesser of 1) 50 percent of wages paid or 2) 25 percent of wages paid plus 2.5 percent of the unadjusted basis of depreciable property used in the taxpayer's trade or business. It may be useful to elect S corporation status as a mechanism to increase wages by paying salaries to shareholders who are also employees.

§ 4.03 Taxable, Tax-Free and Tax Deferred Transactions

[1] Taxable Transactions

Taxable acquisitions can take the place of an equity or asset purchase. The immediate tax consequences of the transaction are imposed on the seller. The purchaser of a business will generally not recognize a gain until the business interest or asset(s) acquired are sold.

In an equity transaction (the purchase of stock or an equity interest in a partnership), the seller will generally realize a capital gain or loss on the transaction. The purchaser realizes a capital gain or loss when the stock or equity interest is sold or the entity is liquidated.

In an asset-purchase transaction, the seller will generally recognize ordinary income from the sale of the assets. The purchaser of the assets will generally recognize ordinary when the assets acquired are sold.

[2] Tax-Free Transactions

[a] Property Contributed and Services Provided in Exchange for Ownership Interest

[i] Corporations

Generally, no gain is recognized by a shareholder(s) for the contribution of property in exchange for stock if the shareholder(s) is in control (defined as 80% stock ownership) immediately following the exchange.[6] The basis of the stock received is equal to the basis of the property contributed.[7] Services performed in exchange for stock results in taxable income to the shareholder. The value of the services performed in exchange for stock may be deductible by the corporation.

[ii] S Corporations

Generally, the rules applicable to contributions of property and the performance of services in exchange for stock mirror the C corporation rules.

---

[6] IRC § 351(a)
[7] IRC § 358(a)(1)

Copyright © 2019 Rodger O. Howells, LLC

[iii] Partnerships

Contributions of property in exchange for an ownership interest are generally not taxable.[8] There is no control after the exchange requirement similar to that applicable to corporations. Taxable income is recognized by a partner if services are provided in exchange for a partnership interest unless the services are provided only for a right to receive future profits and no interest in capital is received.[9]

[iv] Sole Proprietorships

Sole proprietorships (including single-member limited liability companies taxed as a sole proprietorship) are the alter ego of the owner. Contributions to a sole proprietorship are ignored for tax purposes.

[v] Corporate Mergers and Spin-Offs

No gain or loss in recognized under IRC 368 if two corporations are consolidated and the acquiring corporation has control of the other corporation immediately after the acquisition.

In a spin-off under IRC 355, no gain or loss is recognized by shareholders who receive stock of a controlled corporation if the shareholders are in control of the new corporation after the spin-off. To be tax-free the distributing corporation and the new corporation must be in engaged in an active business after the spin-off.

[3] Tax Deferred

[a] In General

In tax-deferred transactions, the basis of assets acquired in exchange for other assets is the basis of the assets given up. The built in gain of the asset given up in exchange for another asset will be recognized when the asset is sold.

[b] Like-kind Exchanges - IRC 1031

Generally, if real property held for investment or used in a trade or business is exchanged for real property held for investment or used in a trade or business, no gain or loss is recognized. If boot is received, gain is recognized to the extent of boot received. Boot is cash or property that is not real estate. Losses are not recognized on like-kind exchanges.

---

[8] IRC § 721(a)
[9] Reg. §1.721-1(b)(1); Rev. Proc. 93-27

Copyright © 2019 Rodger O. Howells, LLC

Real property obtained in a like-kind exchange must be used in a trade or business or held for investment. The taxpayer cannot use the property acquired for personal use. The use of property acquired in an exchange as a residence is not considered a like-kind exchange. A residence is not considered an investment under IRC 1031. Second residences and vacation homes held for personal use are also not considered an investment.[10]

Gain is recognized on a like kind exchange to the extent of boot received. Boot received from a like-kind exchange does not create additional gain. The realized gain is computed using the rules referenced above. The realized gain is recognized to the extent of boot received. Example: If the realized gain on the exchange of property is $100 and the taxpayer receives $150 in cash (boot), the taxpayer has a recognized gain of $100.

Example: Land worth $150,000 with a basis of $100,000 is exchanged for land worth $130,000 and cash of $20,000. The realized gain on the exchange is $50,000 (computed as amount realized of $150,000 ($130,000 value of land plus $20,000 cash) less the $100,000 basis of the property given in the exchange). The amount of recognized gain is $20,000, the amount of boot received.

Example: In the example above, if the land traded had a basis of $140,000, the realized gain would be $10,000 (computed as $150,000 (the value of the land received plus cash received) less the $140,000 basis of the property given). The recognized gain would be $10,000 even though $20,000 of boot (cash) was received in the exchange.

[c] Tax Cuts and Jobs Act

Exchanges of personal property (equipment, etc) used in a trade or business or held for the production of income qualified for like-kind exchange treatment prior to 2018. Under the Tax Cuts and Jobs Act, only exchanges of real estate qualify for like-kind exchange treatment.

§ 4.04 Mitigating Tax Liability

[1] In General

Generally, the purchase of a business operating as a corporation or partnership can be accomplished by either 1) purchasing stock or an equity interest or 2) purchasing the assets of the corporation or partnership. The purchase of a business operating as a sole proprietorship is considered an asset purchase.

In an asset purchase, the tax affects of the transaction work in opposite directions for the buyer and the seller. Asset purchases are more advantageous to the buyer as they afford quicker cost recovery of the purchase price. The sale of an equity interest is more advantageous to the seller because they often lead to capital gains treatment of any gain realized on the sale.

---

[10] *Moore v. Commissioner*, TC Memo 2007-13

Copyright © 2019 Rodger O. Howells, LLC

[2] Cost Recovery and Equity Purchases

The cost of purchasing corporate stock or a partnership interest will not be recovered until the stock or partnership interest is sold, or the corporation or partnership is liquidated.

[3] Asset Purchases and Cost Recovery

The asset purchase method of acquiring a business results in a deduction of the purchase price based on the cost recovery rules. The asset expensing election is generally available for personal property used in a business (defined as property other than real estate). Intangible assets such as goodwill and real estate have longer recovery lives but yearly amortization and depreciation deductions of a portion of the purchase price is allowed. The cost of inventory purchased is recovered when the inventory is sold.

[4] IRC 1060

The purchase of a group of assets for a lump-sum amount that make up a business is considered a purchase of each individual asset. The buyer and seller must allocate the purchase price using the residual allocation method unless the buyer and seller enter into a written agreement as to the allocation of the purchase price. The allocation of the purchase price is governed by the rules under IRC 1060.

Under residual method the purchase price of assets are allocated to each class of property in descending order. Generally, amount allocated to each asset class cannot exceed fair market value of that class on the purchase date. An exception is goodwill (a class VII).

Classes of property

- Class I - cash and deposit accounts
- Class II - certificates of deposit, U.S. government securities, and publicly traded stock
- Class III - accounts receivable
- Class IV - inventory
- Class V - fixed assets including equipment, buildings, vehicles, and land
- Class VI - Intangible assets (as defined in IRC 197) including covenants not to compete entered into in connection with purchase of a business. This class does not include goodwill.
- Class VII - goodwill

When assets are purchased for a lump sum the cost basis of each individual asset is calculated by multiplying the lump sum purchase price by the fair market value of an asset/combined total fair market value of all assets purchased. Example: a taxpayer purchases a group of assets for $90,000 with a combined fair market value of $100,000. The fair market value of each asset is as follows:

Copyright © 2019 Rodger O. Howells, LLC

Land - 10,000

Equipment - 50,000

Inventory - 40,000

The purchase price is allocated as follows:

Land - 10,000/100,000 x $90,000 = $9,000

Equipment - 50,000/100,000 x $90,000 = $45,000

Inventory - 40,000/100,000 x $90,000 = $36,000

Instead of using residual allocation method, the purchaser and seller may enter into a written agreement as to fair market value of assets. The written agreement is binding on both parties. The IRS may disallow allocations that do not follow the written agreement. A corporation was not permitted to change its method of accounting and subdivide assets into categories with new useful lives (reclassifying certain nonresidential real property as tangible property) to secure more favorable depreciation deductions after a written agreement was entered into between the buyer and the seller.[11]

Both the buyer and seller of assets that make up a business are required to complete IRS Form 8594 (see the back of this section). The identifying numbers of both parties involved in the transaction are required to be entered on the form. Form 8594 is attached to the income tax returns of both the buyer and seller in the year the transaction occurred.

§ 4.05 Tax Evasion vs. Tax Avoidance

[1] Tax evasion

Tax evasion can take the form of multiple, related transactions designed to create deductions with no out-of-pocket costs. An example is the "Son of Boss" tax shelters that were marketed in the early 2000s. This tax shelter was used as a mechanism to offset capital gains resulting from the sale of a business.

The "Son of Boss" tax shelter[12] was designed to transfer assets and liabilities to a partnership in exchange for a partnership interest. The liabilities transferred took the form of obligations to purchase securities. The transferor partner would receive an inflated basis in the partnership interest without a corresponding adjustment for the related liability transferred. The partnership would then sell the over inflated asset as a loss (but not at an out of pocket loss for the contributing partner). The partner would then use the artificial loss to offset taxable gains from the sale of a business.

[11] *Peco Foods, Inc. & Subsidiaries v. Commissioner*, TC Memo 2012-18
[12] *Sala v. United States*, 613 F.3d 1249 (10th Cir. 2010)

Copyright © 2019 Rodger O. Howells, LLC

[2] Tax Avoidance

A taxpayer "may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes".[13] Transactions such as the transfer of asset by shareholders to a corporation under IRC 351 will be afforded the benefit of the statute so long as the sole purpose is not tax motivated. In other words, the transaction must have some valid business purpose.

Additional factors that courts may use to determine whether there is a business purpose for a transfer include:

- Whether the transfer fulfilled its stated purpose.
- The extent to which the transferor, rather than the transferee, benefitted from the transfer.
- The extent to which the transferee needed the property.
- The length of time between the transfer and subsequent events.
- The number of such transfers.
- The taxpayer's expertise in tax matters.
- The transactions' form.

[13] *Helvering v. Gregory*, (69 F.2d 809)(2d Cir. 1934)

Copyright © 2019 Rodger O. Howells, LLC