Tax Impact

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Tax Tips

Don't overlook tax considerations when selling your business

When the COVID-19 pandemic first hit, economic uncertainty caused many business owners contemplating a sale — as well as many prospective buyers — to put their plans on hold. Now that there's some light at the end of the pandemic tunnel, interest in buying and selling businesses seems to be picking up.

If you're thinking about selling your business, be sure you understand the tax implications. The way that your business (as well as the transaction) is structured can impact your tax bill and, therefore, your net proceeds from the sale. Here are some issues to consider.

Stock sale vs. asset sale

If your business is a corporation (either an S corporation or a C corporation), deciding whether to structure the transaction as a stock sale or an asset sale may have a significant impact on its tax treatment. Generally, a stock sale is preferable from the seller's perspective. That's because when shareholders sell their stock, the profits generally are taxed at favorable long-term capital gain rates — currently a top rate of 20%, compared to a current top rate of 37% on ordinary income. In contrast, asset sales usually generate a combination of ordinary income and capital gains, depending on how the purchase price is allocated among the business's various assets.

From the buyer's perspective, on the other hand, an asset sale is usually the structure of choice. A buyer of stock generally inherits the corporation's basis in its assets. If the corporation has already taken significant depreciation deductions on those assets, there may be little or no basis for the buyer to write off. But a buyer of assets generally receives a basis equal to the portion of the purchase price allocated to each asset, generating valuable tax write-offs.

Entity type

The seller's form of business is another important consideration. If the seller is a C corporation, for example, a potential drawback of an asset sale is double taxation.

First, the business pays corporate tax on any gains from the sale. Then the shareholders are subject to a second tax when the sale proceeds are distributed

What about state taxes?

Business owners usually focus on the federal tax implications of a sale, but don't ignore state taxes. Now that federal tax rates are lower than they've been in the past, state taxes may take on added significance. If you're contemplating relocating or retiring to another state, it may make sense to consider moving before you sell the business, especially if the new state has low, or even no, income tax.

Before you attempt this strategy, however, be sure to consult your tax advisor. Changing your domicile and residence for tax purposes isn't like flipping a switch. You'll need to take several specific actions to demonstrate your intent to establish a permanent place of abode in the new state, such as obtaining a driver's license, registering to vote, and becoming involved with local organizations and activities.

Keep in mind, also, that there may be rules about the number of days spent in the state, so if you do all of the above to show that you're a resident of your new state, there are other factors. For instance, if you live in your "old" state most of the year and spend only a few months in your new state, you could find that, at least for tax purposes, you're deemed as a resident of both states.

to them as dividends. (Note: It may be possible to defer the second tax by having the corporation hold and invest the sale proceeds.) Double taxation isn't an issue for stock sales. The buyer acquires the stock directly from the shareholders, so there's no entity-level tax.

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Double taxation usually isn't a concern for S corporations. As pass-through entities, their income is taxed directly to shareholders at their individual tax rates. So, there's no entity-level tax, even if the transaction is structured as an asset sale.

There's a possible exception for a business that had previously been taxed as a C corporation but later elected S corporation status. Depending on how much time has passed, asset appreciation during the business's time as a C corporation may be subject to two levels of tax.

Partnerships (including limited liability companies taxed as partnerships) don't have stock, but it's possible for the owners to sell their partnership or LLC membership interests to a buyer. It's important for the sellers to understand, however, that this isn't the same as selling stock for tax purposes. A sale of partnership or LLC interests is treated essentially as a sale of the underlying assets, typically resulting in a mix of ordinary income and capital gain to the sellers.

Allocation of the purchase price

When a transaction is structured as an asset sale, the allocation of the purchase price among various assets has significant tax implications for both buyer and seller. Often, the parties have conflicting interests, which can lead to intense negotiations on this issue. Keep in mind that the parties' allocation of the purchase price isn't binding on the IRS, though the IRS generally will respect the parties' agreement so long as it bears a reasonable relationship to asset values.

Sellers generally prefer to allocate as much of the purchase price as possible to goodwill and other intangible assets that generate lower-taxed long-term capital gains. And they prefer to allocate as little as possible to equipment and other depreciable assets. Why? Because previous depreciation deductions taken on these assets are subject to "recapture" at ordinary income tax rates. Buyers, on the other hand, prefer to allocate as much of the price as possible to these assets because they can depreciate them quickly or in some cases claim 100% bonus depreciation in the first year.

Knowledge is power

To successfully negotiate the sale of your business, it's critical to understand the tax implications. Armed with this knowledge, you can assess the impact of various transaction structures and purchase price allocations on your net proceeds from the sale and potentially adjust the purchase price accordingly. Your tax advisor can help guide you through the sale of your business. ■

Out with the old?

Not so fast when it comes to disposing of tax records

During the COVID-19 pandemic, most people have spent a lot of time at home, inspiring many to clear out some of the clutter in their living spaces. If you've decided to tackle the boxes, bins or drawers full of paper files that have accumulated over the years, you may be wondering when it's safe to dispose of tax records.

General rules

Generally, you should keep tax records — at a minimum — until the statute of limitations has expired. During that time, you can amend your return to claim a credit or refund (or correct an error) and the IRS can audit your return and assess additional taxes. In either case, it's critical to retain all of your tax forms and supporting documentation, including receipts, canceled checks, and bank and brokerage statements.

When does the limitations period expire? As a general rule, it runs for three years from the date you timely file your return or the original due date, whichever is *later*. So, for example, if you filed your 2020 return on March 1, 2021, the limitations period expires on April 15, 2024. But if you applied for an extension and file your return on September 30, 2021, the limitations period expires on September 30, 2024.

Don't get out the shredder just yet, though. In some cases, the statute of limitations stretches beyond three years. For example, it doubles to six years if you've understated your adjusted gross income by more than 25%, which doesn't necessarily mean you failed to report items of income.

An understatement can also result if, for example, you overstate the basis of property sold, thereby underreporting your gain. Also, the IRS is never barred from auditing your return and assessing tax if you don't file a return or if the IRS alleges that your return was fraudulent.

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To be safe, it's advisable to keep tax records for at least six years; indefinitely if you don't file a return for a particular year or if you've taken any aggressive tax positions that the IRS might later characterize as inappropriate.

Exceptions for certain records

Special rules apply to certain types of records. For example, retain:

- Tax returns for at least six years, in case the IRS later claims that you failed to file a return.
- W-2s at least until you start receiving Social Security benefits, in case a question arises about your work record or earnings in a particular year.
- Real estate-related records until the limitations period (three or, preferably, six years) has expired for the tax year in which the property was sold. Original closing documents plus records of capital improvements over the years will help you substantiate your adjusted basis in the property and, therefore, the amount of gain on the sale.
- Investment records until the limitations period has expired for the year in which you disposed of the investments.
- Any relevant records that are related to retirement accounts until the limitations period has expired for the year in which you emptied an account.

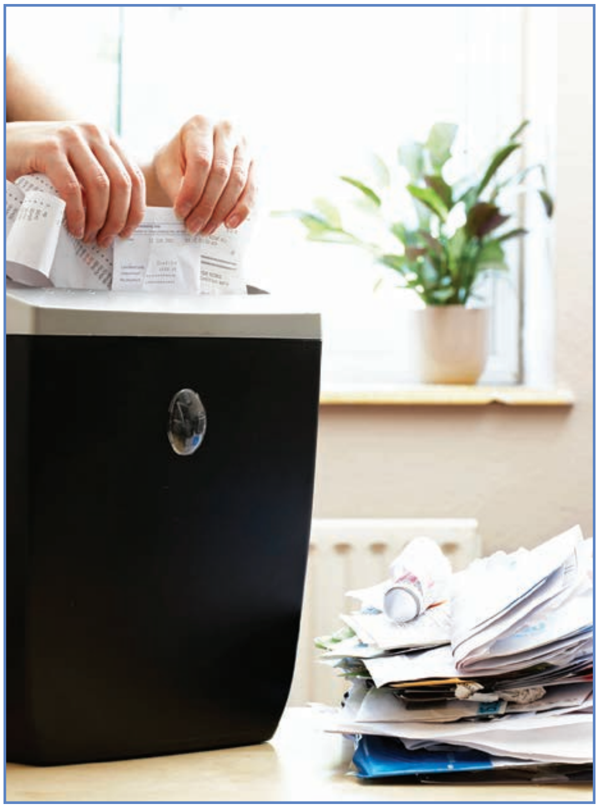
Also, the IRS recommends that you retain records for at least seven years if you claim a loss for a bad debt or worthless securities.

Consider going paperless

Scanning original records and storing them on external hard drives, CD-ROMs or in the cloud can be a great way to declutter without destroying records. The IRS permits you to store tax records electronically, so long as they're accurate and readily produced if needed. Your tax advisor can help you determine whether your electronic storage system meets IRS requirements.

Better safe than sorry

Before you dispose of any tax records, find out whether your state has document retention rules that differ from IRS requirements. And be sure you don't need the records for non-tax purposes — requirements imposed by your insurance company or lender, for example. ■



In your own words

A letter of instruction complements a will

A smart estate plan should leave no doubt as to your intentions. Writing a letter of instruction can go a long way toward clearly communicating all of your thoughts and wishes. The letter, unlike a valid will, isn't legally binding, but can be valuable to surviving family members.

The devil is in the details

Although the content can vary from person to person, one of the main purposes of a letter of instruction is to provide details on final wishes that haven't been covered in the will. Think of the letter as a way to fill in some of the "gaps" or resolve matters left open to interpretation.

For example, the letter can detail vital financial information that has been omitted or glossed over in the will. Typically, this will include an inventory of real estate holdings, investment accounts, bank accounts, retirement plan accounts and IRAs, life insurance policies, and other financial assets.

Along with the account numbers, list the locations of the documents, such as a safe deposit box or file cabinet. And don't forget to provide the contact information for your estate planning team. Typically, this will include your attorney, CPA, investment advisor and life insurance agent. These professionals can assist your family during the aftermath.

Content is up to you

There are no hard-and-fast rules for writing a letter of instruction. The basic elements are outlined above, but the choices are ultimately up to you. Remember that the letter isn't legally binding, so there are no obligations to include any particular item. Conversely, you can say pretty much whatever else you want to say.

Your letter can go into as much or as little detail as you like. However, you'll probably want to provide simplified guidelines for your loved ones to follow during an emotional time.

Rewrite if necessary

Completing the letter of instruction isn't the end of the story. You may have to revisit it for rewrites or edits you didn't accommodate before. For example, you could have neglected to specify certain accomplishments you want mentioned in an obituary.

In addition, it's likely that some of your personal information will change over time, such as bank account numbers and passwords. Update the letter when warranted. Think of it as an ongoing process.

Finally, make sure that the letter is secured in a safe place. Any printed version should accompany your will or be located somewhere else that is accessible to trusted family members. At the same time, you must be able to update the letter whenever you need to.

Clarity counts

If you haven't done so already, draft a letter of instruction and, most important, make sure that others know where and how to locate it. Your attorney or estate planning advisor can help fill in the blanks if you need help. ■

Are you eligible for energy-efficiency tax breaks?

The Consolidated Appropriations Act (CAA) extended certain tax breaks for energy-efficient buildings that were set to expire at the end of 2020. So, now may be a good time for eligible real estate owners and developers to review the potential benefits.

First, the CAA made permanent the Section 179D commercial buildings energy-efficiency tax deduction. Sec. 179D allows commercial building owners (and certain lessees) to deduct up to $1.80 per square foot for the installation of qualifying energy-efficient lighting, HVAC, and building envelope systems in new or existing buildings. Architects, engineers or contractors who design government-owned energy-efficient buildings may also be able to claim the deduction.

The CAA also extended, through the end of 2021, the Section 45L tax credit. Sec. 45L provides eligible home builders and apartment developers with a credit of up to $2,000 for each new dwelling unit that meets certain energy-efficiency standards. ■

Take advantage of the Work Opportunity Tax Credit

As the economy recovers from the COVID-19 pandemic, many businesses will need to hire new employees. If your business is in the same boat, consider the potential benefits of the Work Opportunity Tax Credit (WOTC). Extended by the CAA through 2025, the WOTC can reduce taxes by as much as $2,400 per hire for companies that hire workers from certain disadvantaged groups, such as ex-felons, food stamp and welfare recipients, unemployed veterans, certain empowerment zone residents, and disabled workers referred by a qualified vocational rehab program.

To qualify for the credit, a company must complete specific paperwork and take certain other steps before extending a job offer. So, be sure to familiarize yourself with the requirements and screen all applicants for WOTC eligibility. ■

Charitable deduction for non-itemizers extended through 2021

Ever since the Tax Cuts and Jobs Act nearly doubled the standard deduction, far fewer taxpayers are itemizing deductions. Generally, taxpayers who don't itemize are unable to deduct charitable contributions. But last year's CARES Act provided non-itemizers with an above-the-line deduction (in other words, a deduction from gross income in calculating adjusted gross income) of up to $300 in eligible donations in 2020.

The deduction was available only for cash gifts to public charities other than donor-advised funds or supporting organizations. There was some uncertainty about whether joint filers were entitled to a $600 above-the-line deduction, but in the 2020 instructions to Form 1040, the IRS clarified that the $300 deduction limit applied to both individuals and married couples filing jointly. The CAA extended the above-the-line charitable deduction through 2021 and increased the deduction to $600 for joint filers. ■