THE CASE

Judith Pierce and her son, Paul Pierce, started a business that rents out heavy duty pick-ups to tradesmen who travel to Southern California. The business was an early entry into this growing market. In 2016, Big Trucks, LLC, purchased 24 Sierra 2500HD crew cabs from McClellan Buick-Pontiac-GMC for $800,000 to be used as rentals. The business operates through referrals from existing rental agencies at the airport and elsewhere. When a rental company has a renter for one of the units, it is rented by Big Trucks to the agency, which, in turn, rents it to the customers. This is a strong business model since it is unnecessary overhead for each rental agency to keep its own stock of large pickup trucks.

In 2019, the Pierces have decided to go a different direction with a new business plan and have offered all the assets of Big Trucks for sale to a national equipment leasing company, LeBron Leasing Specialists, Inc.. The company balance sheet currently reflects assets having tax bases and estimated market values as shown in Exhibit 1.

The tentative cash price for the assets is $850,000. Notice the value of the business exceeds the sum of the values of the identified assets by $165,000. This represents goodwill and other intangibles not identified in the balance sheet. The sellers are also paid $100,000 under a separate enforceable non-compete covenant.

Exhibit 1

Asset	Basis	Estimated Market Value
Equipment (Cost = $800,000)	$0	$475,000
Lease (the ground lease is transferable and the lease payments are below current market)	0	25,000
Leasehold improvements (building on the leased land, Cost = $90,000)	85,585	100,000
Solar panels (Cost $40,000, purchased 35 months before the sale)	0	35,000
Inventory (parts, supplies, etc.)	$0	$50,000
Total	$85,585	$685,000

REQUIRED CALCULATIONS FOR THE SELLER

Calculate the gains and losses to Big Trucks LLC and specify the tax character based on the market values presented above. This will require determination of depreciation recapture (if any), Section 1231 gain or loss, capital gain or loss, and investment credit recapture (if any), as well as the treatment of the covenant not to compete.

REQUIRED CALCULATIONS FOR THE BUYER

Determine the tax treatment of each of the LeBron Leasing Specialists, Inc**.,** including the treatment of the covenant not to compete based on the market values presented above.

NEGOTIATIONS

Break into groups and within groups form two teams: one representing the buyer; the other, the seller. Evaluate the transaction as a whole and debate how the values of the specific items might be renegotiated as long as they are reasonable. For example, it might be reasonable to negotiate that the vehicles are worth $100,000 less and the covenant not to compete should be $100,000 less. If this, or similar, changes are made does one party gain or lose advantage? If so, should the total price be affected?

DISCUSSION QUESTIONS

Question 1

Assume for a moment that the Big Trucks LLC is a regular corporation. Why, or why not, would the owners be interested in a stock sale rather than an asset sale. Explain your answers

Question 2

It is generally recognized that buyers and sellers of businesses have conflicting motivations with respect to allocation of purchase price. Using the balance sheet of Big Trucks, LLC, give several examples of how a buyer and seller might differ in their purchase price allocation preferences.

Question 3

Is there an alternative to sale of the solar panels? If so, explain how this might work and what the potential tax benefit might be.

Question 4

How might the new IRC § 199A qualified business income deduction impact this transaction? Be specific by identifying assets that might produce qualified business income. Will the purchase affect the buyer's IRC § 199A deductions?

TEACHING NOTES

STRUCTURE OF A SMALL BUSINESS SALE

Small business sales may be structured as a sale of the assets (including goodwill or going concern value), or as a sale of the stock or ownership interest. According a leading small business sale transaction database (DealStats), over 80% of small business sales are structured as a sale of assets. There are many pros and cons to each structure, but, from the buyer's standpoint, an asset sale is clearly advantageous. Not only does the buyer avoid liability exposure from the seller's operations, but the buyer gets to increase the tax bases of the acquired assets resulting in increased depreciation and amortization benefits.

ASSET VALUATION

In an asset sale, the identifiable assets of the business must be appraised to determine fair market value. U.S. Treasury Regulation §25.2512-1 provides the definition of fair market value for tax purposes: "The value of the property is the price at which such property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell, and both having reasonable knowledge of relevant facts." A discussion of items to be appraised and reasons for appraisals is available at firstbusiness.com. Internal Revenue Code § 1060 (IRC) provides guidance regarding allocation of purchase price to the acquired assets:

(a) GENERAL RULE. In the case of any applicable asset acquisition, for purposes of determining both—

(1) the transferee's basis in such assets, and

(2) the gain or loss of the transferor with respect to such acquisition, the consideration received for such assets shall be allocated among such assets acquired in such acquisition in the same manner as amounts are allocated to assets under section 338(b)(5). If in connection with an applicable asset acquisition, the transferee and transferor agree in writing as to the allocation of any consideration, or as to the fair market value of any of the assets, such agreement shall be binding on both the transferee and transferor unless the Secretary determines that such allocation (or fair market value) is not appropriate.

In most instances, the buyer and seller of a business must file Form 8594 (https://www.irs.gov/pub/irs-pdf/f8594.pdf), which includes details as to the fair market value of various assets. The instructions to the form indicate that, in general, ". . . both the purchaser and seller must file Form 8594 and attach it to their income tax returns . . . when there is a transfer of a group of assets that make up a trade or business . . . and the purchaser's basis in such assets is determined wholly by the amount paid for the assets. This applies whether the group of assets constitutes a trade or business in the hands of the seller, the purchaser, or both" (https://www.irs.gov/pub/irs-pdf/i8594.pdf).

Valuations are based on market value, and the value assigned to an asset cannot exceed its fair market value. If a return is examined, the ". . . Internal Revenue Service may challenge the taxpayer's determination of the fair market value of any asset by any appropriate method and take into account all factors, including any lack of adverse tax interests between the parties" (https://www.law.cornell.edu/cfr/text/26/1.338-6).

The significance of the last part of this statement, and the reason why the IRS generally accepts the agreed to values, is that in almost every instance what is favorable for the buyer is unfavorable for the seller. For example, if more value is assigned to inventory and supplies, the seller has more ordinary income and the buyer enjoys a more immediate ordinary deduction.

BUSINESS VALUATION

Valuation of a business can be arrived at using any number of methods including industry related multipliers based on gross receipts, net cash flow analyses based on some definition of net income, and asset appraisals if there are no significant unidentified intangibles (First Business). One example of a multiplier deals with sales of CPA firms where the market value of the firm is typically around 1 to 1.35 times annual revenue (West). Since customer loyalty and sustaining goodwill are always an uncertainty, payouts may be based on sustained billing, i.e., a percentage based on actual future billings, or some uncertain future indicator (Sinkin).

Business brokers are available for owners who are not prepared to appraise the assets, the business as a whole, or who are not prepared to execute the transaction (Accounting Broker).

TAX CONSIDERATIONS: NEW AND OLD

The following paragraphs address the tax factors, particularly those affected by the Tax Cuts and Jobs Act of 2017 (TCJA 2017), involved in the sale and purchase. The treatment of various assets common to many business sales, including the sale of hypothetical Big Trucks, LLC, are addressed.

Tax Rates

The Tax Cuts and Jobs Act of 2017 (TCJA 2017) significantly altered tax rates and calculations. These individual rates, and most other non-corporate changes, are scheduled to be temporary for calendar years 2018–2025. The corporate tax rates are scheduled to be permanent.

Corporate Tax Rates

The corporate rate was reduced for years beginning in 2018 and beyond from a progressive structure, with rates from 15 to 35 percent, with even higher marginal rates over some ranges, to a flat 21 percent (IRC, § 11).

Individual and Estates and Trusts Rates

The rates for other entities, i.e., individuals, estates and trusts, were cut from a high of 39.6 to 37 percent. The brackets were altered somewhat, and the rates were lowered within most of the brackets (IRC § 1).

The "ordinary" rates and capital gain rates should be available to the students since not all sales of businesses result solely in capital gains and not all ordinary income gains are taxed at the highest rates.

Other structural changes for individual taxpayers that affected tax burdens were numerous. Large shifts in burden were caused by the repeal of the personal and dependency exemption deductions (still in existence but were set at $-0-), the doubling of the child tax credit, the approximately doubling of the standard deduction, and the cap on the itemized deduction for personal state and local taxes at $10,000. These structural items, other than the rate changes, affect tax burden, but they do not significantly affect the analyses in this study, so they will not be discussed further.

Capital Gains Rates for Individuals, Estates and Trusts

Capital gains rates remained essentially the same, with rates of 0 percent for lower income taxpayers, 20 percent for very high-income taxpayers, and 15 percent for most others. There are two additional capital gains rates. The maximum rate on dispositions of collectibles and § 1202 stock (IRC), which are not applicable in this study, remains at 28 percent. The maximum rate on "unrecaptured §1250 gain" (IRC), which could apply to sales of businesses that own real estate, is 25 percent. "Unrecaptured § 1250 gain," is gain on the disposition of depreciable real property to the extent of depreciation allowed or allowable. Gain in excess of the 25 percent gain is subject to the 0 percent for lower income taxpayers, 20 percent for very high-income taxpayers, and 15 percent for most others.

Qualified Business Income Deduction

Congress created a large disparity between the tax rates for corporations and other taxpayers, creating a disadvantage for pass-through entities operating businesses, i.e. sole proprietorships, partnerships, and electing S corporations. Rather than causing a near mandatory shift for pass-through entities to switch to corporate status, Congress implemented what is called the qualified business income (QBI) deduction under new Code § 199A (IRC). This is an artificial deduction, not requiring any outlay of resources.

A detailed explanation of the QBI deduction is beyond the scope of this study, but since it could impact decision making, QBI is summarized here. This deduction cannot exceed 20 percent of QBI, or if smaller, 20 percent of taxable income before the QBI deduction. For taxpayers below established thresholds, i.e. taxable income before the QBI deduction of $326,600 for married filing jointly and $163,300 for others (2020 amounts), the deduction is simply 20 percent of QBI, or if smaller, 20 percent of taxable income before the QBI deduction.

Taxpayers whose taxable incomes exceed these thresholds are subject to a QBI deduction cutback over the next $100,000 for married and $50,000 for others. For example, married taxpayers with taxable income of $426,600 or more would get no QBI deduction because their deduction is fully cut back.

This cutback can obviously eliminate the benefit of the QBI deduction. Higher income taxpayers, other than taxpayers in service businesses, will enjoy a QBI deduction to the extent of a floor equal to 50 percent of W-2 wages or 25 percent of W-2 wages plus 2.5 percent of investments in depreciable assets, whichever is larger. If the married couple in the example above paid W-2 wages of $120,000, their QBI deduction would be $60,000, not to exceed 20 percent of QBI or 20 percent of taxable income before the QBI deduction.

QBI is generally just what it sounds like. It excludes investment type income, including capital gains and losses, and salaries and wages. For purposes of this study, a question arises as to what gains and losses upon the sale of a business for the seller and what deductions for the buyer, affect QBI. For example, gain on the sale of inventory and supplies should be QBI for the seller and reduce QBI for the buyer, assuming the buyer is not a regular corporation since corporations do not benefit from the QBI deduction. Capital gains are not QBI for the seller, but depreciation and amortization deductions for the buyer reduce QBI, again, assuming the buyer is not a regular corporation. These, and other determinations may change over time, as this deduction is new, and uncertainties still exist.

Inventory and Supplies

Any gain or loss from the sale of inventory and supplies is ordinary income or loss. A new twist was created by the Tax Cuts and Jobs Act of 2017(TCJA 2017), in that § 448 of the Internal Revenue Code (IRC, also see Revenue Procedure 2018-40) was amended to allow small businesses with gross receipts of $25 million or less to use the cash method of accounting and discontinue accounting for inventory as well as for the burdensome uniform capitalization procedure (IRC § 263A). Eligible businesses choosing to no longer account for inventory can simply treat purchases of goods similar to the treatment of supplies.

This really doesn't change the treatment of the sale of a business, but the gain attributable to the inventory to the seller will be greater since the basis will be zero. The buyer may be able to immediately expense the inventory if the buyer is eligible.

Equipment

Any gain attributable to equipment in a business sale will likely involve depreciation recapture under § 1245 (IRC). This recapture, of course, is ordinary income. On the buyer side, the taxpayer will be able to expense the entire cost since TCJA (TCJA 2017) allows 100 percent bonus depreciation for purchased property, including used property (IRC, § 168(k)). Prior to TCJA, used property was not subject to bonus depreciation.

Solar Panels

If the solar panels are sold along with the other assets of the business, part or all of the cost recovery deductions and the investment tax credit (ITC) will need to be recaptured. Specifically, the seller would have $35,000 of depreciation recapture, based on the $35,000 fair market value, and be required to pay back 60 percent of the ITC as recapture, resulting in a cash outflow of $7,200. ITC must be recaptured at a rate of 20% per year for each part or full year short of five years (i.e., three years in this case). The recapture of $7,200 is $40,000 x 30 percent credit x 60 percent.

The purchaser would not be entitled to a solar tax credit since the credit is only available to the original owner of the panels, so the panels could simply be expensed under bonus depreciation with no energy credit.

It is clear the panels could be removed from the structure and installed somewhere else. As a result, the seller should be able to sell the building and retain title to the panels. The seller could then retain title and sell energy to the buyer. After the credit is fully earned at the end of five years, a decision could be made as to whether to sell the panels, or not.

Real Estate Including Improvements on Ground Leases

Tax reform did not significantly affect the tax treatment for sale of real property.

<u>Sale of Real Property</u>

Depreciable property and land used in a trade or business that is held for more than one year is § 1231 property. Depreciable § 1231 property that is real property is not technically subject to depreciation recapture. But, as described previously, net gain is 25 percent capital gain to the extent of "unrecaptured § 1250 gain." Any remaining gain on improvements and land is 15 percent gain, or 0 percent for very low income taxpayers and 20 percent for very high income taxpayers.

<u>Acquisition of Real Property</u>

For a buyer, real property is classified as residential rental property or nonresidential real estate as before and depreciated using straight line and lives of 27.5 and 39 years, respectively (IRC,

§ 168). Real estate improvements constructed on rented land are depreciated the same as those on land that is owned by the taxpayer.

Leases and Contracts

If value is assigned to leases or similar contracts in which the owner has no basis, capital gain should be allowed. For example, if the seller entered into a favorable lease and the rent was lower than the prevailing market, the lease has value. The leases and contracts can be amortized over the life of the assets; however, they are not §197 assets (IRC).

Other Intangible Assets

Most other intangible assets will be §197 assets (IRC). Internally generated assets like goodwill generally qualify for capital gain treatment to the seller. Those that were purchased and amortized are §1231 assets (IRC) and any amortization deductions are subject to recapture under §1245 (IRC).

Section 197 property (IRC) can be amortized over a period of 15 years.

Covenants Not-to-Compete

A separate agreement not to compete adds another element to a business sale. The overall price is certainly affected by the potential future competition from the seller. One explanation, by Steven Thompson, follows:

> "When a business is sold, it is not uncommon for a portion of its sale price to be attributable to a noncompete agreement between the seller and the buyer. For tax purposes, a covenant not to compete is recognized when it is severable from goodwill, the agreement is separately bargained for, and the covenant can be shown to have economic substance. When this is the case, the portion of the sale price attributable to goodwill is generally treated as a capital asset, and the payment received for the noncompete agreement is taxable as ordinary income under Revenue Ruling 69-643, 1969-2 CB 10 (Thompson)."

The buyer is entitled to an ordinary deduction as a business expense for periodic payments to the seller for the agreement not to compete.

EFFECT OF NEGOTIATIONS

For the seller, as has been indicated, sales of some assets result in capital gain or loss; others, ordinary income or loss. For the buyer, purchases of some assets result in immediate expensing; others, deferred deductions, or in the case of land, no deduction at all until the land is sold. Since § 1060 (IRC), and other authorities, respect allocations of value between the various assets, the buyer and seller can negotiate, not only the price for the business, but the reasonable fair value of the underlying assets.

Generally, in such negotiations, what is good for the buyer is not good for the seller, and vice versa. For example, with inventory, the seller has ordinary income (bad, but it might be QBI, which is good) and the seller has an ordinary deduction (good, but this might reduce QBI, which is bad). So, in negotiations, the buyer would favor a relatively high value for inventory, while the seller would prefer a lower value.

Another example is goodwill. For internally generated goodwill, the seller has capital gain and the buyer has a § 197 (IRC) asset that can be amortized over 15 years. In this case, the seller would prefer a higher value for goodwill, while the buyer would prefer a lower value since the buyer typically seeks current deductions.

As indicated, if it would be reasonable based on facts and circumstances, the buyer would negotiate for a higher value for inventory and a lower value for the goodwill. The seller has the opposite inclinations. These negotiations could, due to the give and take and varying tax rates between the buyer and seller (perhaps 21 percent for a corporation and 37 percent for an individual), result in renegotiating the overall price upward or downward. This is referred to as “tax arbitrage” (Investopedia).

It is important to realize that tax arbitrage could affect these negotiations. A corporate buyer might be willing to give up some ordinary deductions, rather than deferred deductions, for a slight increase in the overall price. A non-corporate seller might accommodate the change to get more capital gain.

STOCK OR OWNERSHIP INTEREST SALES

Our discussion so far has dealt with asset sales. If the business is operated as a partnership, including an LLC reporting as a partnership, limited liability company, or a corporation, including an S corporation, there is the option to sell the partnership interest, member interest, or stock. An elaborate discussion of the issues here will be left for another day. However, it is unlikely that the buyer of a partnership or an S corporation would gain from acquiring an ownership interest or stock over purchasing the assets.

<u>Sale of Corporate Stock</u>

The sale of stock in a regular corporation seems appealing, but an informed buyer would not pay as much for the stock of a corporation with appreciated assets, as they would for the appreciated assets because they would keep the low basis in the underlying assets resulting in less deductions. This is compared to the fair market value, as negotiated, basis in purchased assets that result in larger deductions.

<u>Sale of Partnership Interest or S Corporation Stock</u>

The sale of an interest in a partnership or S corporation might seem tempting, but in an asset sale, the gain or loss flows through to the owners and retains its character as capital gain or ordinary income. Since the owner's basis in the entity goes up by any gains and down by any losses, and since the buyer gets a basis equal to cost, there is no benefit to acquiring a partnership interest or stock in an S corporation.

There are complex rules for the sale of a partnership interest that further complicate things. Even though a partnership interest is generally treated as a capital asset (IRC, § 741), ordinary income that would have been recognized had the underlying ordinary assets been sold will be recharacterized as ordinary income (IRC § 751(a)).

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REQUIREMENTS

Tax Calculations for the Seller

	Gain or Loss	Character
uipment	$475,000	All ordinary income under § 1245
ase	$25,000	Long-term capital gain--15%
asehold improvements	$14,415	§ 1231 gain: $10,000 15% gain;
		$4,415, unrecaptured § 1250 gain (i.e,.25% gain)
lar panels	$35,000	Only one-fifth of the credit has been earned; three-fifths must be recaptured.
		Since the entire credit was 30%, or $10,500, $6,300 must be recaptured.
		One-half of the credit reduced the basis in the panels, so one half of the recaptured credit is added back to basis.
		Since the basis is now $3,150, the gain is $31,850 ($35,000 - $3,1500
		All of the gain is ordinary income under § 1245
ventory	$50,000	All ordinary income.

The seller has 15% capital gain related to the $165,000 received for the internally generated intangibles.

The seller has ordinary income for the payments for the covenant not to compete.

Tax Calculations for the Buyer

Equipment can be deducted under § 168(k) additional first-year (bonus) depreciation.

The $25,000 assigned to the lease can be amortized over the remaining term of the lease.

The leasehold improvements can be depreciated over 39.5 years for nonresidential real estate.

The solar panels can be deducted under § 168(k) additional first-year (bonus) depreciation.

No investment tax credit is allowed to a purchaser other than the original purchaser.

Inventory can be expensed if the buyer has gross receipts under the $25 million threshold (indexed for inflation). Otherwise, the inventory can be expensed when used or sold.

The covenant not to compete must be amortized over its life. The buyer gets an ordinary deduction.

NEGOTIATIONS

Generally, what is good for the buyer is bad for the seller, and vice versa. Therefore, the government generally accepts the allocation that is arrived at by the buyer and seller.

DISCUSSION QUESTIONS

Question 1

Perhaps the most important consideration involves the basis in the assets. If a corporation owns the assets, the corporation retains the basis in the assets compared to the effects when the buyer buys assets and the basis is cost. Let's look at the equipment: in a stock sale, the basis in the equipment stays at zero; in an asset sale, the basis is cost based on fair market value. In an efficient market, the stock would not be worth $850,000 due to the opportunity cost of not claiming the deduction for the cost of the equipment. Similar sacrifices apply to each of the other assets.

Question 2

The seller will seek to increase capital gains and to minimize ordinary income. Therefore, the seller will push for a lower allocation to equipment and to inventory. Equipment will result in ordinary income due to IRC § 1245 recapture. Sale of the inventory will produce ordinary income due to its nature. Reductions in allocation of purchase price to one or both of these assets will increase the residual purchase price that is allocated to goodwill, a capital gain asset for the seller.

The buyer will be looking for ordinary deductions. Assuming the buyer meets the new IRC § 448 requirements and will not be required to maintain inventory as an asset, allocation of purchase price to inventory will produce an immediate ordinary deduction (although this may negatively impact the buyer's IRC § 199A deduction). Amounts allocated to equipment will provide an immediate deduction under § 168(k), additional first year depreciation. Increases in the allocation to inventory and equipment will reduce the amount of the purchase price allocated to goodwill, an asset that will produce amortization over 15 years.

Question 3

To avoid recapture on sale of the solar panels, the panels could be maintained by the seller and leased to the buyer of the business until the recapture period ends. This would entail the seller negotiating to exclude the panels from the assets being transferred, something that would probably only be possible if the transaction is structured as an asset sale.

Question 4

Sale of the business will likely have implications for both the buyer and seller in terms of the IRC § 199A qualified business income deduction. For the seller, the amount allocated to sale of the inventory will produce qualified business income ("QBI"). While less clear, § 1245 recapture on sale of the equipment and solar panels may also provide QBI with the companion deduction. On the buyer side, purchase and expensing of inventory, equipment, and the solar panels will reduce QBI and could negatively affect the buyer's § 199A deduction.

		Strongly Disagree						Strongly Agree
		1	2	3	4	5	6	7
Pre-case questionnaire								
1.	I understand the tax implications of selling a business.							
2.	I understand and can apply depreciation recapture provisions under IRC § 1245.							
3.	I understand the energy credit recapture rules and can apply them.							
4.	I understand and can apply the allocation of purchase price rules applied in sale of a business.							
5.	I understand the differences between an asset sale and sale of an interest in a business sale transaction.							

		Strongly Disagree						Strongly Agree
		1	2	3	4	5	6	7
Post-case questionnaire								
1.	I understand the tax implications of selling a business.							
2.	I understand and can apply depreciation recapture provisions under IRC § 1245.							
3.	I understand the energy credit recapture rules and can apply them.							
4.	I understand and can apply the allocation of purchase price rules applied in sale of a business.							
5.	I understand the differences between an asset sale and a sale of an interest in a business sale transaction.							
6.	I found the case interesting.							
7.	Case studies are useful in learning how the tax rules work in practice.							
8.	The case provided a realistic setting to study tax in connection with the sale of a business.							
9.	The case was clearly written and the requirements were easy to understand.							
10.	Completing the case required more than the textbook for the class.							
11.	The case required me to integrate knowledge of several accounting topics.							
12.	The case helped me understand how to estimate tax liability in sale of a business.							
13.	The case challenged me to think critically about how a CPA can add value to a business sale transaction.							
14.	The level of difficulty of the case was appropriate for the weight in							

	the course's grade.							
15.	Overall, the case added value to the course.							
16.	I would recommend this case to other instructors.							