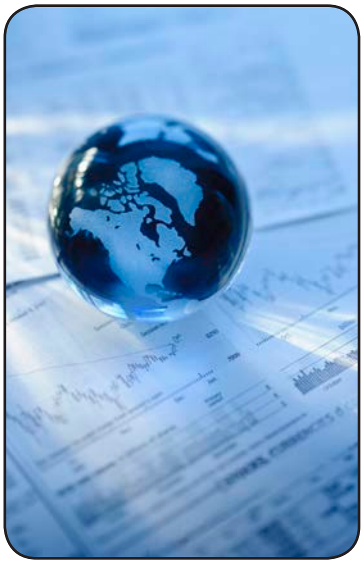

Business Dispositions

Tax and Business Update

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Classifying Gains and Losses

The sale of business assets results in taxable gains and losses to the seller. Gain or loss must be determined for each asset sold—this requires allocating part of the total sales price to each asset when multiple assets or an entire business are sold.

Whether a sale yields capital (lower tax rate) or ordinary (higher tax rate) gains or losses depends on the classification of the assets sold. Assets fall into three categories:

Capital Assets	Tax Code Section 1231 Assets	Other (Ordinary Income) Assets[1]
Property *other than*: • Inventory. • Trade receivables and notes. • Real and depreciable trade or business property. • Certain copyrights; musical, literary and artistic compositions; letters; memoranda; and U.S. government publications.	• Real and depreciable trade or business property held more than one year. • Intangible personal property amortizable under Code Section 197. • Certain livestock. • Certain timber, coal and domestic iron ore. • Certain unharvested crops.	• Inventory. • Trade notes and accounts receivable. • Real or depreciable trade or business property that would be Code Section 1231 property if held long enough.

[1] The sale of these other assets generates ordinary gains and losses that do not receive any special tax treatment.

Individual Capital Gain Tax Rates

Type of Gain	Holding Period	Ordinary Tax Rate Bracket						
		10%	15%	25%	28%	33%[1]	35%[1]	39.6%[1]
Short-term	≤ 1 year	10%	15%	25%	28%	33% 36.8%[2]	35% 38.8%[2]	39.6% 43.4%[2]
Long-term[3]	> 1 year	0%	0%	15%	15%	15% 18.8%[2]	15% 18.8%[2]	20% 23.8%[2]
Unrecaptured Section 1250	> 1 year	10%	15%	25%	25%	25% 28.8%[2]	25% 28.8%[2]	25% 28.8%[2]

[1] Capital gains and qualified dividends for taxpayers in these tax brackets will likely also be subject to the 3.8% tax on net investment income.
[2] This rate includes the additional 3.8% tax on net investment income.
[3] Special maximum rates apply to capital gains from sales of collectibles and qualified small business stock.

Tax Code Section 1231 Gains and Losses

Section 1231 gains and losses receive special tax treatment:

- A net Section 1231 gain for the year is treated as a capital gain.
- A net Section 1231 loss for the year is treated as an ordinary loss.
- Section 1231 gains and losses from partnerships, LLCs and S corporations are passed through to the owners, and these rules are applied at the owner level.

Applicable rates—individuals:

- A 25% maximum rate applies to gain up to the amount of depreciation not already treated as ordinary income recapture (see following).
- Gains over and above the ordinary income and unrecaptured amounts qualify for the capital gain rate for individuals (20% maximum, depending on the taxpayer's marginal tax bracket).

Applicable rates—corporations:

- There is no difference in the corporate tax rate on capital gain income versus ordinary income.
- The distinction between ordinary income and capital gain income becomes significant when a corporation has capital losses that can only be offset against capital gains.

Partnerships, LLCs and S corporations. Capital gains and losses are passed through to partners (LLC members) and shareholders, and the capital gain rules then apply to the owners based on their type of entity.

C corporations. Net capital gains are taxed at the same rates as ordinary income. Net capital losses can't be deducted in the current tax year. However, a net capital loss can be carried back three years or forward five years to offset capital gains.

Ordinary Income Recapture

- Gains from selling certain depreciable real estate, personal property and other assets are taxed as ordinary income for some or all of the taxable gain (Code Section 1245 and 1250 recapture).
- Includes gains from amortizable intangible personal property.
- Gain exceeding ordinary income recapture is Section 1231 gain.
- No recapture when a business asset is sold at a loss.
- C corporations are subject to additional recapture rules for depreciable real estate.
- The Tax Code contains other recapture provisions, such as those for oil, gas and other mineral properties.

C Corporation Stock Sales

Advantages:

- Usually the simplest transaction.
- Assuming the stock is not registered with the SEC, a transaction can be closed quickly.
- Favorable tax consequences to the owner (capital gain).
- Deferred payments usually qualify for installment reporting, which defers the owner's tax liability to the year payments are received.

Disadvantages:

- Purchasers are generally willing to pay less for stock than for the business assets, since all of the corporation's known and unknown liabilities remain with the stock.
- Potential liabilities or unwanted assets may make it difficult to find a purchaser willing to acquire stock at a price at which the seller will sell.
- Commercial lenders may not be willing to lend funds necessary to buy a closely held business, forcing sellers to finance the sale and significantly defer their cash proceeds.
- A seller financing the sale retains risk since repayment depends on the success of the purchaser running the business.

Installment Sales

- An installment sale is any property sale where at least one payment is received after the close of the tax year of the sale.
- Under the installment method, the seller recognizes a portion of each payment as taxable gain when payment is received. Each payment will usually consist of three parts: (1) interest, (2) gain on sale and (3) recovery of basis.
- Losses are not eligible for installment reporting.
- Installment method reporting is mandatory unless the seller elects out of it.

What is the benefit to the seller? The benefit of reporting gain using the installment method is that it enables the seller to report the gain over several years. Thus, the seller's tax on the sale is normally paid as cash is received.

Caution: Gain subject to ordinary income depreciation recapture is taxed in the year of sale, even with an installment sale.