Optimize Tax Planning On The Sale Of Your Business

Should You Exchange Your Intellectual & Personal Property?

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The sale of a business creates many opportunities for planning: estate planning, business succession planning, and income tax planning are just a few of the topics business owners are faced with at this critical juncture. However, all too often, the business owners and their tax advisors hyper-focus on the conversion of those assets into cash. This one dimensional approach, does not fully take into account what is the end goal of many selling business owners: repositioning the business owner's value into income-producing investments which produce a more tax-efficient return on equity. In some cases, there may be tax savings opportunities.

Take for example a hypothetical coal company in Kentucky trading as Cleaner Coal Technologies. Cleaner Coal Technologies has been in business for twenty years. The primary owner, Henry Duggett, wants to sell Cleaner Coal Technologies, move to the Powder River Basin and reinvest the sales proceeds in new equipment, a new brand, and a new physical plant. The company recently received an offer to purchase all outstanding shares and the ownership entity for twenty million dollars. If Henry had significant negotiating power, he might be able to simply sell his stock and pay long-term capital gains on the sale. If he had the right buyer, he might be able to negotiate a tax free reorganization under IRC § 368 and then use his new stock as collateral for a loan to finance his new company. However, most buyers will either want to purchase the assets only or insist that the stock sale be classified as an asset sale under IRC § 338(h)(10). As such, the purchase price would be allocated among all of the company's assets under IRC §1060 and Henry would have to pay taxes on the net capital gains taxes at the federal and state level. This gain would be exacerbated by depreciation recapture on any capital assets that were depreciated during the last twenty years. All-in-all, the sales price of twenty million dollars could be reduced as much as 35-40%.

If Henry considers an asset sale, then his tax advisor should be looking for other opportunities to save him money. In Henry's case, he should exploring the possibility of like-kind exchanges. If Henry were to "map out" his sale and repurchase and convert his ownership in equipment, intellectual property, and real estate into new equipment, intellectual property, and real estate, Henry could bury his cost basis into his new investment and successfully defer a majority of his capital gain. Goodwill of one company is never going to be like-kind to the good will of another company. Treas. Reg. §1.1031(a)- 2(c)(2). Nevertheless, in ILM 200911006, the IRS clarified that intellectual property "such as trademarks, trade names, mastheads, and customer-based intangibles can be separately described and valued apart from goodwill." The IRS further pointed out that exchangeclients must take heed of the like-kind definitions applicable to intellectual property and personal property and must make sure that their replacement property is like-kind in both the nature and character according to Treas. Reg. § 1.1031(a)-2(c)(1). Furthermore, Treas. Reg. § 1.1031(a)-2(b) provides that depreciable tangible personal properties are of a like class if they are either within the same General Asset Class (as defined in Treas. Reg. § 1.1031(a)-2(b)(2)) or within the same Product Class (as defined in Treas. Reg. § 1.1031(a)-2(b)(3)). Whether intangible personal property is of a like-kind to other intangible personal property generally depends on (i) the nature or character of the rights involved (e.g., a patent or a copyright) and (ii) the nature or character of the underlying property to which the intangible personal property relates.

Two examples are provided in the regulations concerning exchanges of intangibles. In Treas. Reg. § 1.1031(a)-2(c)(3), Example 1, Taxpayer K exchanges a copyright on a novel for a copyright on a different novel; these properties were of a like-kind. In contrast, in Example 2, Taxpayer J exchanged a copyright on a novel for a copyright on a song, and the properties exchanged were deemed not of a like-kind. Thus, both the nature or character of the rights involved and the nature or character of the underlying property are taken into account.

As tax advisors, deeper levels of planning provide more areas for you to create value for your clients. The tax planning related to the sale of a business, in particular, gives an opportunity to create a competitive advantage over your peers.