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TAX AND BUSINESS ADVISOR

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TAX AND BUSINESS Alert™

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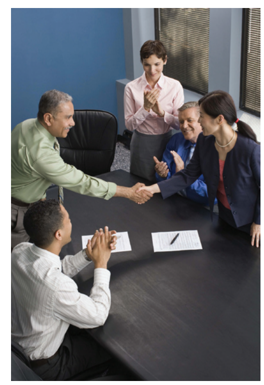
Selling a Corporate Business

When selling a corporate business, there are several ways to minimize the resulting tax bill. This article summarizes some of the more important tax and business considerations.

Existing corporate businesses can basically be sold in two ways: by selling either the business assets or the corporate stock. Buyers often prefer to purchase the assets of an existing business to have some protection from acquiring unknown or contingent liabilities, while sellers normally prefer to sell the stock of the corporation that conducts the business. A sale of stock by noncorporate shareholders (e.g., individuals) generally results in long-term capital gain that is taxed at a current maximum rate of 15%. (This long-term capital gain rate is currently scheduled to increase to 20% in 2013.) Because of the single level of taxation associated with a taxable stock sale, sellers usually prefer it to an asset sale followed by liquidation of the corporation, which may result in a greater tax liability.

The tax results of an asset sale are generally less favorable to the sellers since the corporation is generally liquidated to get the sales proceeds into the sellers' hands. Thus, a C corporation is taxed on the gain from the asset sale. Then, the shareholders are taxed on the liquidation proceeds as if they had sold their stock for the cash and any property distributed in complete liquidation of their stock, resulting in double taxation.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While sellers generally favor stock transactions, they may prefer an asset sale in the following circumstances:

1. The selling corporation may have unused net operating loss or capital loss carryforwards that can offset any corporate-level gain on the sale of its assets.

2. If the assets to be sold have a high basis, there may be no corporate-level gain from the sale. If the shareholders' stock basis exceeds the value of the liquidation proceeds, gain at their level could also be avoided.

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2012 HSA Limitations

Health Savings Accounts (HSAs) were created as a tax-favored framework to provide health care benefits mainly for small business owners, the self-employed, and employees of small- to medium-sized companies who do not have access to health insurance.

The tax benefits of HSAs are quite favorable and substantial. Eligible individuals can make tax-deductible (as an adjustment to AGI) contributions into HSA accounts. The funds in the account may be invested (somewhat like an IRA), so there is an opportunity for growth. The earnings inside the HSA are free from federal income tax, and funds withdrawn to pay eligible health care costs are tax-free. The dual benefit of tax-deductible contributions into and tax-free withdrawals from HSAs (and existing Medical Savings Accounts) is truly unique, as no other tax-deferred type of account currently offers such a benefit.

The 2012 inflation-adjusted deduction for individual self-only coverage under a high deductible plan is $3,100, while the comparable amount for family coverage is $6,250. For 2012, a high-deductible health plan is defined as a health plan with an annual deductible that is not less than $1,200 for self-coverage and $2,400 for family coverage, and the annual out-of-pocket expenses (including deductibles and copayments, but not premiums) must not exceed $6,050 for self-only coverage or $12,100 for family coverage.

Electric Vehicle Credits

If the high cost of gasoline has you looking for alternative transportation options, an electric vehicle might be the answer and may qualify for one of the following federal tax credits that are currently available to help reduce the cost of an electric vehicle.


Ford Motor Co.

Plug-in Electric Drive Motor Vehicle Credit. This credit for qualified plug-in electric drive motor vehicles ranges from $2,500 to $7,500, depending on the battery capacity. The credit will be phased out for each manufacturer after it sells 200,000 vehicles.

Plug-in Electric Vehicle Credit. This credit is available for certain low-speed electric vehicle and two- or three-wheeled vehicles. The credit equals 10% of the vehicle's cost, up to a $2,500 maximum credit for purchases made before 2012.

Credit for Conversion Kits. This credit equals 10% of the cost of converting a vehicle to a qualified plug-in electric drive motor vehicle that is placed in service before 2012. The maximum credit is $4,000.

Please contact us to discuss these electric vehicle credits or any other tax planning or compliance issue.

Safeguarding Tax Records

With the 2011 hurricane season officially under way and highly destructive tornadoes striking throughout the country earlier this year, it's a good time to review some IRS suggestions for safeguarding tax records. The IRS suggests taxpayers keep a set of backup records in a safe place away from the original set. This is more easily accomplished now that many financial institutions provide statements electronically and other financial information is readily available on the Internet. Even if the original records are on paper, they can be scanned into an electronic format. Next, taxpayers should photograph or videotape important personal or business assets. Finally, emergency plans should be reviewed and updated, since personal and business situations change over time as do preparedness needs.

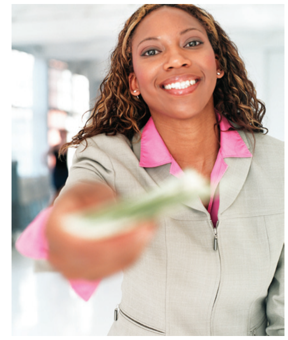
There are several ways to extract cash from a closely held C corporation. The purpose of this article is to alert you to the tax planning opportunities that exist if you intend to tap into that hard-earned business cash.

Corporate Distributions

Historically, dividend treatment has been something to avoid because of the double taxation issue. In effect, dividends are subject to double taxation because your corporation pays income taxes on the earnings that generate the dividends, on which you also pay income taxes when the earnings are paid out to you. This harsh effect has been softened somewhat by the lowering of the maximum qualified dividend tax rate to 15%. However, in 2013 (barring any intevening tax legislation) this favorable tax rate will expire.

A planning strategy for a closely held C corporation is to calibrate shareholder-employee salary and bonus payments to reduce the corporation's annual taxable income to the $50,000 level and minimize the combined shareholder-owner/corporate tax liability. Sometimes, however, intentionally arranging for you to receive double-taxed dividends can be beneficial. For example, a dividend paid by your corporation begins to become tax-efficient compared to a deductible payment when your income tax rate is 28% or higher, and your corporation's tax rate does not exceed 15%. As long as the corporation's top rate is 15%, dividends become relatively more tax-efficient as your personal tax rate increases to 33% and 35%. Note that the top individual rate is currently scheduled to increase to 39.6% in 2013.

Your corporation may have built up substantial earnings and profits over the years. A profitable corporation becomes exposed to the accumulated earnings penalty tax when it accumulates earnings in excess of reasonable business needs and does not pay dividends. Right now, the accumulated earnings tax rate is only 15%. However, after 2012, the accumulated earnings tax rate will return to the maximum individual federal rate on ordinary income. Therefore, now is a good time to pay out dividends and reduce your corporation's exposure to this penalty tax.



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Another way for you to tap the earnings that have built up in your corporation is to arrange to distribute cash and or property for your stock. This is called a stock redemption. A stock redemption may be treated as a sale in some cases, which qualifies for capital gain or loss treatment. Sale treatment would be preferred if you have a substantial basis in your stock. Sale treatment is a good thing because the maximum tax rate on long-term capital gains is currently only 15%, but is scheduled to increase to 20% in 2013.

As you can see, the current low federal tax rates on both dividends and long-term capital gains make the idea of taking corporate distributions worth considering. With careful planning, we can determine whether dividend treatment or sale treatment is best for you. Please contact us if you have questions or want more information on this or any other tax planning issue.

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3. An asset sale by a C corporation should be more acceptable to sellers who plan to use the proceeds to acquire a new business that will be operated in the same corporate shell as the old business (thus avoiding the second level of tax on the sale because the proceeds are not distributed to the shareholders).

As you can see from this discussion, a stock transaction often results in the best tax and business answer for the seller, so please contact us and we will be glad to work with you to structure any disposition transaction in the most favorable way, considering all tax and general business issues.

Tax Planning for Mutual Funds

If you have ever had to go back and find mutual fund records from several years in the past, you know how painful that process can be. You may have been forced to endure searching through several years of mutual fund and broker's statements or confirmations looking for mutual fund transaction information to have your tax return prepared. If you do manage to find those old statements, you may then be faced with computing the actual cost basis of your mutual funds after allowing for the reinvested fund distributions received each year, additional purchases, and partial sales. However, with an improved record-keeping system and some careful planning, you can avoid the headaches associated with locating investment information, ease the cost basis computation burden, and increase the after-tax rate of return on your mutual funds.

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If you elect to reinvest your periodic mutual fund distributions (as many investors do), those distributions generally increase your cost basis for determining taxable gain or loss. Even when your mutual fund distributions are reinvested, you pay taxes on them in the year received [current taxation is not applicable to tax-deferred retirement accounts, such as a 401(k), IRA, etc.], and each reinvestment is like making a new purchase with its own cost basis and holding period. Therefore, when you sell or redeem your mutual fund shares, it's critical you include that additional cost basis when computing your gain or loss. If you don't, you may pay double the tax since you were already taxed in the year the distribution was received. Keeping track of that additional cost basis can be complicated, but it's necessary, as keeping accurate records could result in lower taxes.

When you sell or redeem mutual fund shares without liquidating your entire investment position in the fund, you have choices for determining how much cost basis is assigned to the shares sold. If you have purchased shares on different dates and at different prices, the method used can significantly affect the amount of taxable gain or loss and the holding period, which in turn determines whether you qualify for the preferential long-term capital gain tax rates.

Another planning issue relates to choosing mutual funds in which to invest. Although you cannot control the fund's timing of internal investment sales (and their capital gain recognition and distribution), you can choose a fund that is managed with a level of tax efficiency that fits your particular situation.

Please contact us for more ideas on tracking your mutual fund investments and saving taxes.