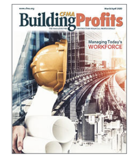




BY RICH SHAVELL

# Tax Implications of Selling a Construction Business

Your owner has built a successful construction company and has decided it's time to hang up their tool belt and sell the business. You've found a buyer and agreed on a price. How much cash will be deposited into their brokerage and savings accounts once the sale is completed?

While the details of the purchase and sale agreement will dictate the tax implications, consulting with experienced professionals early may help maximize the after-tax proceeds.

This article will explore various tax implications to owners of S corporation pass-through entities when selling their businesses.[1]

## Stock Sale or Asset Sale

A business sale is usually structured as either a stock sale or an asset sale.

### *Stock Sale*

From a tax perspective, stock sales are simpler as the seller relinquishes their shares in the corporation in exchange for the proceeds. The seller recognizes a capital gain on the excess of the purchase price over their stock's tax basis, which is then taxed at capital gain rates ranging from 0-20%[2] depending on the seller's total taxable income.

Generally, the seller's tax basis is the amount previously paid for the stock plus the accumulated earnings.[3] In most cases, this amount is the accumulated adjustments account, *plus* the original capital contribution, *plus* the additional paid-in capital contributed to the company.

Consider Bob, the owner of the S corporation Builder, Inc., who is selling all 100 shares of his company to Tim for $10 million; $1 million of the purchase price is allocated to a consulting agreement payable to Bob over three years. Therefore, Bob receives a $9 million stock sale price for his shares in the company ($10 million - $1 million consulting agreement).

Assuming that Bob's original tax cost (contribution) for capital stock was $5,000 as well as $995,000 in accumulated earnings leaves him with a total cost basis of $1 million. He will recognize a long-term capital gain of $8 million ($9 million stock sale price - $1 million stock basis).

And, assuming he has no offsetting capital losses, he will pay $1.6 million in federal taxes on the capital gain ($8 million x 20%). Depending on where he lives and where the business is located, state and/or local income taxes may also apply. A 3.8% surtax may also apply (as discussed later).

### *Asset Sale*

In an asset sale, the parties allocate the purchase price to the company's assets. Depending on the assets identified in the sale agreement, the seller generally incurs taxes at multiple rates, including ordinary income, depreciation recapture, and capital gain rates.

Capital gains are generally the most favorable and have the lowest rates. Inventory, patents (and other similar intangible assets), and accounts receivables (A/Rs) sold for a gain generate ordinary income.[4]

However, such depreciable assets as furniture, machinery, and equipment generate unique tax results under IRC §1231 gain rules, which may be split between both ordinary income and capital gains.[5] Real property, such as buildings (not including land), generates IRC §1250 gains that also face mixed tax results[6] with a statutory depreciation recapture rate of 25%[7] along with capital gain rates.

## Depreciation Recapture

Because business owners deduct depreciation on fixed assets generally at their ordinary income tax rates, lawmakers concluded that the gains on the sales of those assets should also be taxed as ordinary income to the extent of previously deducted depreciation.

## EXHIBIT 1: **Builder, Inc. Sale of Business: Asset Sale**

| | |
|---|---|
| **Consulting Agreement** | **$1,000,000** |
| **Purchase of Assets** | **$9,000,000** |
| **Total Agreed Price** | **$10,000,000** |

| Assets Sold | Price Allocation | Adjusted Basis | Gain (Loss) | Potential Tax Treatment | Recapture | Capital | Ordinary |
|---|---|---|---|---|---|---|---|
| M&E | $2,250,000 | $350,000 | $1,900,000 | Mixed | $1,900,000 | - | |
| Building | $2,000,000 | $1,250,000 | $750,000 | Mixed | $550,000 | $200,000 | |
| Land | $975,000 | $475,000 | $500,000 | Capital Gain | | $500,000 | |
| Labor Force | $1,200,000 | - | $1,200,000 | Capital Gain | | $1,200,000 | |
| Goodwill | $2,500,000 | - | $2,500,000 | Capital Gain | | $2,500,000 | |
| Inventory | $75,000 | - | $75,000 | Ordinary | | - | $75,000 |
| **Total Assets** | **$9,000,000** | **$2,075,000** | **$6,925,000** | | **$2,450,000** | **$4,400,000** | **$75,000** |
| **Consulting Agreement** | **$1,000,000** | - | **$1,000,000** | Ordinary | | | **$1,000,000** |
| **Total Agreed Price** | **$10,000,000** | **$2,075,000** | **$7,925,000** | | **$2,450,000** | **$4,400,000** | **$1,075,000** |

| Summary Based on Taxable Gain | | | Summary Based on Total Proceeds | | |
|---|---|---|---|---|---|
| Taxable Income & Gains (after adjusted basis) | $7,925,000 | 100.00% | Gross Proceeds | $10,000,000 | 100.00% |
| Less Projected Taxes | ($2,118,250) | -26.73% | Less Projected Taxes | ($2,118,250) | -21.18% |
| Net After Taxes (effective after-tax rate) | **$5,806,750** | **73.27%** | Net After Taxes | **$7,881,750** | **78.82%** |

**Statutory & Ordinary Recapture**

| Section 1250 | Section 1245 | Capital Gain | Ordinary | Total Taxes |
|---|---|---|---|---|
| **25%** | **37%** | **20%** | **37%** | |
| | $703,000 | | | $703,000 |
| $137,500 | | $40,000 | | $177,500 |
| | | $100,000 | | $100,000 |
| | | $240,000 | | $240,000 |
| | | $500,000 | | $500,000 |
| | | | $27,750 | $27,750 |
| **$137,500** | **$703,000** | **$880,000** | **$27,750** | **$1,748,250** |
| | | | | - |
| | | | $370,000 | $370,000 |
| **$137,500** | **$703,000** | **$880,000** | **$397,750** | **$2,118,250** |

This prevents taxpayers from benefitting from depreciation deductions at higher ordinary income tax rates (due to higher marginal income tax brackets of up to 37%) and then later recognizing gains on sales at more favorable capital gain rates.

Moreover, the recognized gains are elevated because the cost basis is reduced by the previously deducted depreciation. In any event, the computed gains in excess of the assets' accumulated depreciation are taxed as capital gains.[8]

As noted, real property faces a depreciation recapture tax at 25% (previously deducted depreciation x 25%) with the excess taxed as capital gains. For example, consider an asset sale where $5.225 million is allocated to fixed assets as follows:

- Buildings = $2 million with an adjusted tax basis of $1.25 million after $550,000 of depreciation (i.e., original cost would have been $1.8 million);
- Tangible equipment = $2.25 million with an adjusted tax basis of $350,000 after $1.9 million in depreciation (i.e., original cost would have been $2.25 million);
- Land = $975,000 with an original cost and adjusted tax basis of $475,000 (note: land is not depreciated for tax purposes); and
- A/Rs less accounts payables (A/Ps) = zero in this specific sale; the parties agree to a cut-off date for these items whereby Bob will collect the receivables owed as of a specific effective date and will similarly be obligated to pay the payables owed on that same date.

The total gain for this group of assets is $3.150 million, computed as $5.225 million selling price less basis of $2.075 million ($1.25 million + $350,000 + $475,000).

Next, we must determine what portion of the gain is capital vs. ordinary for these assets and which rates apply:

- Land has a capital gain of $500,000 ($975,000 allocated price - $475,000 basis);
- The building has a gain of $750,000 ($2 million - $1.25 million basis) that is bifurcated; $550,000 is IRC §1250 recapture taxed at 25% statutory rate and the residual of $200,000 is taxed as regular capital gains;[9] and
- The tangible property/equipment has a gain of $1.9 million ($2.25 million allocated price - $350,000 basis) and is entirely taxed as ordinary income because it does not exceed the depreciation claimed on those same assets.

This implies that the more advantageous capital gain tax rates cause sellers to favor stock sales over asset sales. Why pay taxes at higher marginal *ordinary* income tax rates that could be up to 37% when capital gain rates may be 20% (or 23.8% with the surtax, which is discussed later) or less depending on the taxpayer's circumstances during the tax year in which the gain is recognized?

### QBI to the Rescue

An ancillary issue is whether the highest marginal ordinary tax rate will even apply. Not considered here is the 20% qualified business income (QBI) deduction[10] on pass-through income, which effectively lowers the tax rate on the portions of gain that must be recaptured as ordinary income (see "The New Qualified Business Income: An Overview" in the September/October 2018 issue of *CFMA Building Profits*[11]).

Rather than the highest marginal income tax rate of 37%, a 29.6% effective rate may apply as the highest individual tax rate adjusted by the 20% QBI deduction (37% x 80% = 29.6%).

### Buyer's Deductions/Ancillary Issues

Buyers favor asset sales because of these same ordinary marginal tax rates. If the purchase price is allocated to inventory, depreciable assets, or certain other ordinary income property, then the buyer will recover a portion of the purchase cost sooner as deductions against ordinary income, thereby saving taxes up to 37% (or 29.6% if the QBI deduction is applicable). In a stock sale, all of the buyer's purchase cost is generally only recovered upon a future sale of the entity's stock.

Also with a stock sale, the entity does not change or go out of existence because the buyer "steps into the seller's shoes" as the entity's new shareholder. A specific concern for the purchaser is whether or not they are eligible to be a shareholder of an S corporation. If the intention is to maintain the entity's status as an S corporation, then the buyer must be an individual, qualified trust, or another eligible shareholder.[12]

Also, because the purchased entity legally continues with a stock sale, attorneys often express concerns about hidden or unknown liabilities that may be unknowingly assumed by the buyer. This legal concern typically causes attorneys to recommend asset sales for buyers.

Depending on the market and specific circumstances, buyers typically prefer asset sales while sellers often champion stock sales.

### Net Investment Income Tax

Capital gains generated from a stock sale are normally subject to the net investment income tax (NIIT). The NIIT is a 3.8% surtax on the taxpayer's investment income if they have a modified adjusted gross income above $200,000 for single filers and $250,000 for married taxpayers filing jointly.[13]

The NIIT is in addition to the capital gain tax, raising the highest effective capital gain rate in most cases from 20% to 23.8%. Treasury regulations permit taxpayers an exclusion from the NIIT in cases where the interest or business sold is a nonpassive activity.[14] So if the interest is a business in which the taxpayer materially participates, then the surtax of 3.8% would not apply.

### Installment Sales

The tax impact of a business sale is not always immediate. A common practice is for the seller to obtain a promissory note from the buyer to be repaid over time. In many cases the transaction can be taxed as an installment sale for tax purposes and the seller recognizes both the interest income plus capital gains as the note's principal is paid.

The amount of capital gain recognized each year is the actual cash proceeds received multiplied by the gross profit percentage, which is computed (without the ordinary income portion of the gain) in the initial year of sale.[15] The seller should understand that varying capital gain rates may apply in future tax years if capital gain tax rates change because of legislation or if income levels rise or fall.

Installment sales can be advantageous to sellers in either stock sales or asset sales (with significant capital gains) by spreading capital gain recognition over multiple years, potentially lowering the seller's tax rates in future years. So, in future years, when taxable income is less than the $200,000/$250,000 income threshold previously referenced, then capital gain rates lower than 20% may apply in certain years.

However, sellers with gains taxed as ordinary income, such as depreciation recapture, do not enjoy the same spreading and deferred income recognition. Instead, the full amount of ordinary income is recognized in the year of the sale regardless of when the cash is received.[16] This is a significant concern that could, in some cases, result in a tax liability greater than the initial cash received.

For example, let's again consider the sale of Builder, Inc., and assume that Bob agreed to a down payment of $1 million plus a four-year note with principal payments of $2 million in each of the following four years. Additionally, Bob receives and recognizes an appropriate amount of interest income during the subsequent four years.

Recall that the sale included a $2.25 million allocated sales price for the machinery and equipment. The gain allocated to these specific assets is $1.9 million, and all of this gain is a recapture of previously deducted depreciation. The entire $1.9 million is taxed in the year of the sale regardless of when the cash from the sale of these specific assets is received under an installment sale.

A 29.6% effective tax rate (after the 20% QBI deduction) is multiplied by the $1.9 million resulting in a tax of $562,400. Additionally, let's assume inventory is sold for an allocated price of $75,000, which is also taxed in the initial year of the sale. The result is that Bob pays more than half of the initial year's down payment toward the ordinary income taxes that cannot be a part of the installment sale.

### Mid-Contract Change in Taxpayer

The IRS had considered the tax impact of selling long-term construction contracts when it issued regulations in 2002.[17] The regulations generally state that if there is a mid-contract change in the reporting taxpayer, then the buyer and seller should recognize income based on the date the contract changes hands. This is referred to as a "step-in-the-shoes"[18] transaction.

For sales of contracts, the regulations indicate there may be a "constructive completion" of the contract and the "old taxpayer" would report the income through the date of the transaction.[19]

### Purchase Price Allocation & Reporting for Asset Sales

For asset sales, the seller and buyer must report the allocation of proceeds for the sale.[20] Form 8594 is included and filed with both the buyer and seller's annual tax returns. Naturally, it would be prudent that the forms filed by each respective party are identical, and may require discussion and coordination between the buyer and seller. It is recommended that the allocation of the purchase prices to the various asset categories are specified in the purchase and sale agreement.

When there is a transfer that meets the definition of an applicable asset acquisition (a group of assets that constitute a business), then the residual method is used to compute the asset allocation.[21] The regulations specify seven classes of assets:[22]

1) Class I: Cash and cash equivalents
2) Class II: Actively traded personal property, certificates of deposit, and foreign currency
3) Class III: Mark-to-market assets and debt instruments
4) Class IV: Inventory (stock in trade of the taxpayer or other property of a kind that would properly be included in the inventory, or property held by the taxpayer primarily for sale to customers in the ordinary course of its trade or business)
5) Class V: All assets not included in Classes I, II, III, IV, VI, or VII
6) Class VI: All IRC §197 intangibles (i.e., client lists and in-place labor force) except goodwill or going concern value
7) Class VII: Goodwill and going concern value

The residual method first allocates the lower-tier assets at their fair market values and then allocates the remaining sales price to the higher-tier assets, such as goodwill and going concern value.[23]

Goodwill (and certain other intangibles) may be a key discussion point between the parties because of contrasting tax effects to each seller and buyer. For example, the agreement to the purchase price allocated for hard assets may result in quicker write-offs through depreciation for the buyer, while it may result in ordinary income to the seller because of depreciation recapture.

Conversely, the amount eventually allocated to goodwill is generally a capital gain to the seller while it is a 15-year amortizable asset[24] to the buyer. This conflicting and competing tax result of who gets more immediate tax benefits normally entails negotiation between the parties.

### Special Election: IRC §338(h)(10)

Buyers will sometimes press for a specific election permissible for stock purchase transactions. Under this election, the stock sale is treated as if the S corporation sold all of its assets while it was still an S corporation.[25]

Gain is recognized by the S corporation, creating additional stock basis to the seller and ensuring one level of tax.[26] The S corporation shareholders are treated as receiving sale proceeds in liquidation of the S corporation. The seller is thus taxed on a deemed asset sale and subsequent liquidation rather than as a stock sale.

There are times when a portion of the gain of the deemed asset sale is not a capital gain, but rather an ordinary income (i.e., depreciation recapture); this may be a special election that is disadvantageous to the selling S corporation shareholder(s). The buyer typically initiates the discussion (as both parties must make the election) in order to increase the tax basis of the buyer's newly acquired assets.

Accordingly, buyers may concede an increase in stock purchase price to entice the seller to join in the election. The buyer's incentives are the bonus depreciation rules in the *2017 Tax Cuts and Jobs Act* (TCJA), whereby buyers can elevate first-year depreciation for both new and used assets (i.e., the fixed assets acquired with stepped-up basis via this special election).

## Other Considerations

There are many other tax and nontax issues that arise during the sale of a construction business. For example, there may be tax issues with the portion of the proceeds specified as a consulting agreement (W-2 vs. 1099) for the seller to stay on and assist with the transition. A nontax issue may be the nature and breadth of a noncompete agreement.

For contractors, the cut-off and risk issues with changing to a new surety relationship may also need consideration and should be specifically addressed in the purchase and sale agreement.

Your tax advisor and legal counsel should be familiar with business sales in the construction industry to help raise and address these and other issues.

## Summary

A contractor selling its business should contact its tax advisor to fully understand the tax implications before a purchase and sale agreement is finalized.

At the outset, contractors and CFMs should understand how the transaction is structured, what taxes may apply, and what the projected after-tax proceeds will be for the pending transaction. ■

## Endnotes

1. This article does not consider S corporations that previously converted from C corporations and may be subject to the IRC §1374 built-in gains tax. See "Converting from a C to an S Corporation? Beware the Built-in Gains Tax" in the May/June 2017 issue of *CFMA Building Profits*. *www.cfmabponline.net/cfmabp/20170506?pg=68#pg68*.
2. IRC §1(h)(1)(B), IRC §1(h)(1)(C), and IRC §1(h)(1)(D).
3. IRC §1367.
4. IRC §1221(a).
5. IRC §1231.
6. IRC §1250.
7. IRC §1(h)(1)(E).
8. IRC §1231.
9. Beyond the scope of the simplified example and not considered here is the potential structuring to defer gains on the sale of land and buildings via a three-party IRC §1031 like-kind exchange transaction.
10. IRC §199A.
11. *www.cfmabponline.net/cfmabp/20180910?pg=59#pg59*.
12. IRC §1361(b)(1).
13. IRC §1411(b).
14. Prop. Reg. §1.1411-7(a)(3).
15. IRC §453(c).
16. IRC §453(i).
17. Reg. §1.460-4(k). Note: For simplicity, this article's examples do not consider whether any consideration is allocated to the construction contracts at the effective date of the sale transaction.
18. Reg. §1.460-4(k)(3).
19. Reg. §1.460-4(k)(2).
20. IRC §1060(b).
21. Reg. §1.1060-1(a)(1) and Reg. §1.1060-1(c).
22. Reg. §1.1060-1(a)(1), Reg. §1.1060-1(c), and Reg. §1.338-6(b).
23. Reg. §1.338-6(b).
24. IRC §197(a) and IRC §197(d)(1)(A).
25. IRC §338(h)(10)(A)(ii).
26. IRC §338(b).

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