Sale of the Closely Held Business—Personal Intangible Assets versus Company Intangible Assets

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Prior to the sale of a closely held C corporation, the seller corporation's financial advisers should consider any personal intangible assets that may be operated by the corporation. A "personal intangible asset" is an intangible asset that is created and owned by the corporation owner—but is used by the subject corporation. Personal intangible assets may exist when a shareholder's personal reputation, industry expertise, and/or business relationships contribute significantly to the company business value and expected future cash flow. This discussion summarizes what the closely held corporation owner should consider regarding the identification and documentation of personal intangible assets, particularly with respect to structuring the sale of the closely held C corporation.

Introduction

The sale of a closely held corporation may include the following considerations:

1. Complex income tax planning and compliance considerations
2. Complex business valuation considerations

This discussion summarizes the benefits associated with allocating a portion of the total sale proceeds to personal intangible assets in a sale of a closely held C corporation.

There may be significant federal income tax benefits to both the buyer and the seller in the transaction if personal intangible assets are treated as property that is sold separately from, but in conjunction with, the sale of the closely held corporation assets or stock.

The valuation analyst can serve an important role in both the identification and the valuation of personal intangible assets prior to the sale of a closely held C corporation. These valuation analyses can lead to a transaction structure that is tax efficient for both the close corporation buyer and the close corporation seller.

Taxation in the Sale of a C Corporation

When the corporation owner/operator sells the assets of a closely held C corporation, any gain on the sale of the corporation assets (both tangible assets and intangible assets) is typically taxed twice.

First, the gain is taxed when the corporation sells the assets to the corporation buyer—such as a corporate acquiror.

Second, the remaining gain is taxed again when the asset sale proceeds are distributed from the seller corporation to the individual owner/operator(s).

The closely held business may be organized as an S corporation, a limited liability company (LLC), a limited partnership (LP), or some other type of pass-through entity for federal income tax purposes.

The pass-through type of business tax structure is favorable to the business entity owners from an income tax perspective. That is, the business income

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is generally not subject to federal income tax at the entity level. Rather, the business income is:

1. passed through from the company to the business owners and
2. taxed at the individual shareholder/member/partner level.

Alternatively, the closely held business (and most larger business entities) may be organized as a C corporation for federal income tax purposes. With this type of company tax structure, the business income earned by the C corporation is first taxed at the entity level, at the corporation's federal income tax rate.

The Double Taxation Issue

To the extent that the corporation's after-tax profits are then distributed to the individual shareholders (typically as dividends), the profit distributions are taxed again to the individual business owners. These business profit distributions are taxed at the individual shareholder's federal income tax rate.

For this reason, C corporation business profits are sometimes said to be subject to double taxation—that is, once at the corporation level and again at the individual shareholder level.

Owners of a tax pass-through entity are also advantaged (compared to C corporation shareholders) when the closely held business is sold. This statement is particularly true in the case of a business sale that is structured as a sale of the company assets.

Let's assume that the closely held business owner (who may be planning to retire) sells all of the company assets (tangible and intangible) to a competitor. If the seller company is a tax pass-through entity, then the gain on the sale of the company assets is typically taxed once—at the business owner level.

If the closely held company sells its assets at a gain, then that gain is typically not taxed at the entity level. Rather, the amount of the gain on the company asset sale (including the sale of the business goodwill) is taxed once—at the individual business owner level.

In contrast, let's assume that the selling company is a C corporation. Again, let's assume that the closely held corporation owner decides to sell all of the company assets (both tangible and intangible) to a current business competitor.

To the extent that there is a gain on the sale of the company assets (including the sale of the business goodwill), that gain will first be taxed at the corporation level. When these after-tax gains are then distributed to the company shareholder, these distributions are then taxed again, at the individual shareholder level.

This so-called double taxation occurs because a C corporation is a separate taxable entity from its individual shareholders. So, if the C corporation company sells business assets (tangible or intangible) that are owned by the corporation, then the corporation has to pay income tax on any gain associated with that asset sale.

Planning for The Double Taxation Issue

In structuring the sale of the assets of a closely held C corporation, it is important for the business owner/operator sellers to distinguish between:

1. the sale of any commercial intangible assets that are owned by the company itself and\
2. the sale of any commercial intangible assets (including personal goodwill) that are owned by—and may be sold by—the individual shareholders.

In the federal income tax jargon, such business owner/ operator–owned intangible assets are called "personal intangible assets."

Personal Intangible Assets

Personal intangible assets are more likely to exist when the individual shareholder is actively involved in the closely held business operations and business management.

Typically, these individual intangible assets are created or developed by the individual business owner/operator. The business owner/operator then allows his or her company to use the personal intangible assets in its regular business operations.

These personal intangible assets may include the company owner's customer relationships, supplier relationships, created business methods and procedures, designs and drawings (related to products or processes), and personal goodwill and reputation.

Personal intangible assets consist of intangible assets that are:

1. developed and owned by an individual company owner and
2. held separately from the corporation business enterprise.

The Sale of Personal Intangible Assets

At the time of a sale of the closely held company assets, the individual owner/operator may also have the ability to sell his or her personal intangible assets. It is important that the business asset sale transaction documentation (e.g., the asset purchase agreement) match the character of the transferred assets.

The asset sale may require a contract that is:

1. a separate document for the sale of the business assets and
2. a separate document for the sale of the owner personal intangible assets.

Ideally, the transaction documentation will also allocate the total amount of the business purchase/sale price between:

1. the corporation-owned tangible assets and intangible assets and
2. the individually owned personal intangible assets.

In the closely held C corporation asset sale, the Service may challenge whether some of the transferred intangible assets are, in fact, personal intangible assets. And, the Service may also challenge the allocation of the total business purchase/sale price consideration to the individually owned personal intangible assets.

In order to more effectively respond to such an audit challenge, it would be preferable for the closely held corporation owner/operator to document the existence of personal intangible assets prior to the subject business sale transaction.

A periodic inventory of such personal intangible assets may help convince the Service (and the business acquiror) that such personal intangible assets:

1. did exist over a long period of time and
2. were developed and owned by the individual owner over a long period of time.

In addition, periodic appraisals of the personal intangible assets may convince the Service (and the business acquiror) that these personal intangible assets have a measurable economic value.

With such periodic documentation, it is less likely to appear (as the Service may allege) that the business owner simply "invented" these personal intangible assets at the time of the business sale transaction.

In fact, the Service will often allege that the selling owner invented the whole idea of personal intangible assets just to engineer a favorable income tax treatment related to the sale of the closely held corporation.

Summary and Conclusion

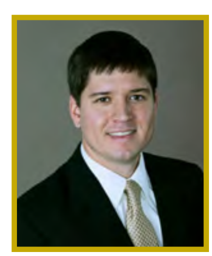
When the business owner sells the assets of a closely held C corporation, it matters how the business sale proceeds are allocated by the buyer and the seller. The gain from the sale of company-owned assets (both tangible and intangible) may be taxed twice—first to the corporation and second to the individual shareholder(s).

However, the gain from the sale of individually owned personal intangible assets may only be taxed once—at the individual selling shareholder level.

Accordingly, it is important for the business owner to properly structure—and to properly document—the sale of the assets of the C corporation closely held business. And, it is particularly important for the owner to properly allocate the business purchase/sale transaction proceeds to any personal intangible assets.

An inventory and appraisal of the owner's personal intangible assets should help the selling business owner to:

1. structure the closely held corporation business sale transaction,
2. document the existence of—and the value of—the personal intangible assets involved in the business sale transaction, and
3. allocate the business purchase/sale transaction proceeds between (a) the personal intangible assets and (b) the corporation-owned tangible and intangible assets.



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