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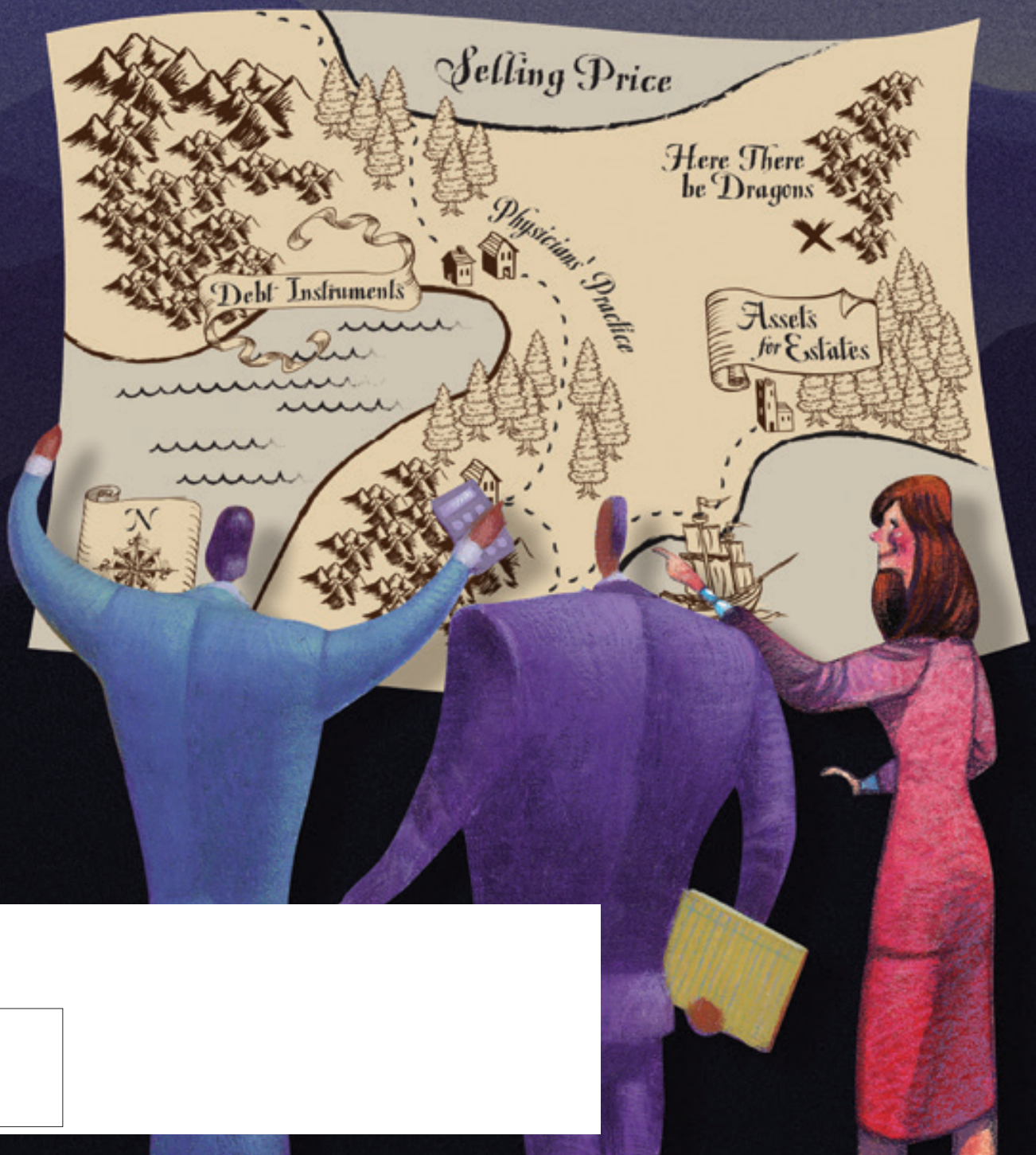
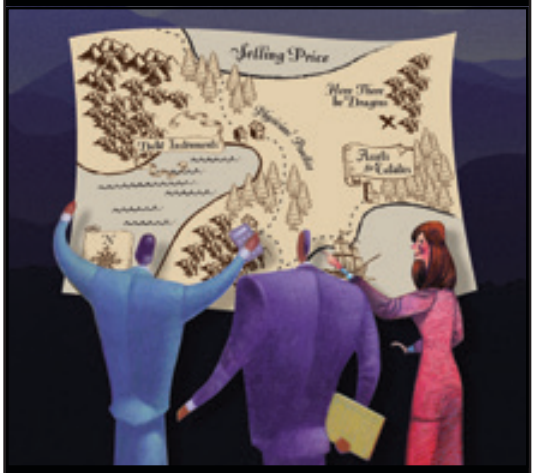
# The Value Examiner®

A PROFESSIONAL DEVELOPMENT JOURNAL *for the* CONSULTING DISCIPLINES

## SPECIAL ISSUE



## On The Cover




SPECIAL ISSUE

### The Challenges Facing Business Valuators

**In this Special Issue** of *The Value Examiner*, we take a look at some of the "hot button" issues facing business valuators. Our contributors examine challenges facing estate planners and valuation professionals, explore the factors that are complicating the valuation of medical practices, and delineate the impact of federal income taxes on transaction prices and terms. In addition, our columnists and guest panel evaluate software tools, highlight a very hardworking sole practitioner, and give tips on getting paid. Finally, our litigation discussions center around two cases that have long reaching impact.

# In This Issue...

# Departments



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**ALL SUBMISSIONS**

*The Value Examiner* is devoted to current, articulate, concise, and practical articles in business valuation, litigation consulting, fraud deterrence, matrimonial litigation support, mergers and acquisitions, exit planning, and building enterprise value. Articles submitted for publication should range from 500 to 3,000 words. Case studies and best practices are always welcome.

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VALUATION

# What to Consider When Using Guideline Transaction Data

*By Eric J. Barr, CPA/ABV, CFF, CVA, CFE*

Income taxes play a major role in the pricing and structure of business transactions because income tax consequences associated with the sale or purchase of a business can substantially reduce the seller's net proceeds and/or lower the net cost of a purchased ownership interest to the buyer. Because of this issue, it seems appropriate to assume that actual transactions are structured by buyers and sellers to address such income tax consequences. This article addresses the impact of federal income taxes on transaction prices and terms, and considers the impact of taxation on the selling prices reported in guideline transaction databases.[1]

Transaction databases provide various pricing multiples of potential guideline company transactions; some include information about the selling terms, whether or not a noncompete was involved, and if there are any contingencies that have been reported for the specific transaction.

However, there is the risk that the transaction price or deal terms reported in the transaction databases reflect material adjustments by both the buyers and sellers regarding income tax consequences. These income tax consequences are primarily focused around (1) the entity form of the seller, and (2) the negotiations between buyers and sellers that influence whether the buyer buys assets or the seller sells the net equity (or stock) of the subject business. Using the transactions in the databases to formulate an indicated value for another business of similar characteristics and *failing to consider the tax consequences of the entity form of the seller or the decision to buy/sell assets or equity embedded in the transaction multiples may result in an improper valuation conclusion by an analyst.*

The entity form of the business being sold dictates whether the seller (equity owner in the business being sold) incurs one or two levels of taxation on the sale of business assets. The decision to sell assets versus equity dictates whether the gain on sale of certain assets involved in the transaction is recognized as ordinary income or capital gains.

When assets are purchased, the buyer will realize a "step-up" in basis to fair-market value of the acquired assets. When equity (stock) is purchased in a C Corporation or an S Corporation, absent an IRC 338 election, the buyer does not receive a "step-up" in basis.

Exhibit 1 (seen next page), which is discussed in more detail below, summarizes the income tax consequences to buyers and sellers of (1) equity ownership interests in C corporations, S corporations, partnerships, limited liability companies, and sole proprietorships; and (2) assets of C corporations, S corporations, partnerships, limited liability companies, and sole proprietorships.

The following is a brief discussion of the tax consequences to the seller and buyer under each of the scenarios presented in Exhibit 1.

## ENTITY FORM OF SELLER: C CORPORATION

The sale of assets by a C corporation results in the seller recognizing ordinary income (loss) on sale of the assets first at the entity[2] level, and second at the

1 This article does not address the impact of state, local, and foreign jurisdiction income taxes on transaction pricing and terms.

2 A C corporation can recognize capital gains, and although taxed for federal income tax purposes at the same rate as ordinary income, the C corporation can use available capital loss carryovers.

**EXHIBIT 1**

| | SELLER | | BUYER | |
|---|---|---|---|---|
| | Ordinary Income (OI) or Capital Gains (CG) | 1 or 2 Levels of Taxation | Inside Basis Same or Different than Seller | Asset Step-Up |
| **C Corporation** | | | | |
| Asset sale | OI & CG | 2 | Different | Yes |
| Stock sale (equity) | CG | 1 | Same | No |
| **S Corporation** | | | | |
| Asset sale | OI & CG | 1 | Different | Yes |
| Stock sale (equity) | CG | 1 | Same | No |
| **Partnership/Limited Liability Company/Sole Proprietorship** | | | | |
| Asset sale | OI & CG | 1 | Different | Yes |
| Stock sale (equity) | OI & CG | 1 | Different | Yes |

shareholder level on receipt of the liquidating distribution when the entity is dissolved. On the other hand, if the seller of a C corporation sells stock, there is only one level of taxation—capital gain/loss at the shareholder level. Accordingly, C corporation sellers have a financial disincentive to sell assets and a financial incentive to sell equity.

From a buyer's perspective, the incentives when purchasing a business from a C corporation are opposite that of the seller. Buying assets will enable the buyer to "step-up" the cost basis of the purchased assets to fair-market value. Thus, a buyer of C corporation assets will likely have a higher cost basis for depreciating fixed assets, and will be able to amortize assets such as goodwill and other intangible assets for tax reporting purposes. The tax deduction benefit of increasing the tax basis of purchased assets could be very substantial.

When the stock of a C corporation is purchased, there is no step-up in basis of company-held assets (inside basis). Rather, the purchaser has a higher basis in the stock purchased (outside basis). The tax savings benefit related to the stepped-up outside basis is only realized on the ultimate sale or disposition of the C corporation stock, which could be many years later. Moreover, when purchasing the stock of the C corporation, all commitments and contingent liabilities of the company remain with the business and can potentially impact the buyer.

Based on these tax issues, it is generally to the seller's disadvantage to sell assets and to the buyer's advantage to purchase assets. Nevertheless, many transactions involve the sale of assets. The valuation analyst should consider the potential tax savings to the buyer and the tax cost to the seller when a C corporation's assets are sold, as the buyer's tax savings may be built into the transaction price.[3] Failing to separately identify the tax savings component of a selling price when C corporation assets are sold could result in an overstatement of value.

## ENTITY FORM OF SELLER: S CORPORATION

S corporations are pass-through entities that, in general, pay no federal income taxes at the entity level. All of the S corporation's taxable income and expenses pass through to the S corporation's shareholders, and the shareholders incur only one level of income taxes on S corporation taxable income.

When an S corporation sells its asset to a buyer, the gain on sale of assets passes through to its shareholders as ordinary income/loss and/or capital gain/loss. Unlike the sale of assets by a C corporation, the sale of assets by an S corporation only results in one level of taxation.[4]

3 Certain databases present transactional data as if on an asset basis; other(s) makes a distinction on whether the actual transaction was an asset or a stock transaction.

4 This analysis assumes that the S corporation is not subject to IRC 1374.

The buyer's tax consequences are the same whether assets are purchased from a C or S corporation. Similarly, the buyer's tax consequences are the same whether equity is purchased from a C corporation or an S corporation.[5]

Based on this discussion, it is once again to the buyer's advantage to purchase assets. However, the disadvantage to the seller when assets are sold is much less as an S corporation than as a C corporation because there is only one level of taxation. There remains a disadvantage to the S corporation seller with respect to selling assets versus selling stock because the sale of assets may result in a portion of the gain being realized as ordinary income, whereas, generally, no portion is recognized as ordinary income when stock is sold. The valuation analyst should again consider the potential tax savings to the buyer and the tax cost to the seller when assets are sold, as the selling price may include some amount for the buyer's tax savings.

## ENTITY FORM OF SELLER

Partnerships, limited liability companies, and sole proprietorships are all pass-through entities. Unlike S corporations, the sale of equity by these pass-through entities are all treated as a sale of assets. The seller recognizes ordinary income (loss) and/or capital gain (loss) from the sale of assets by partnerships, limited liability companies, and sole proprietorships, and this income is only taxed once, at the owner level.

The buyer of assets or equity of partnerships, limited liability companies, and sole proprietorships can achieve a step-up in basis of assets without any adverse tax consequence under IRC 754. Accordingly, it makes no difference to either the buyer or seller if the sale of a business operating as a partnership, limited liability company, or sole proprietorship is structured as a sale of assets or equity.

## EXAMPLES

Now we'll apply these concepts to two examples. XYZ Company, LLC (taxed as a partnership), with an inside equity tax basis of $460, is sold for $1,285. See Exhibit 2 (see next page). Based on the fair-market value of the assets and liabilities, the seller realizes an ordinary loss of $25 on the sale of accounts receivable, an ordinary gain of $100 on the sale of inventory, and a capital gain of $750 on the sale of property and equipment ($300)[6] and goodwill ($450). The buyer realizes a step-up in basis equal to the fair-market value of the assets and liabilities acquired.

Now let's consider the following questions:

1. If the transaction involved a sale of equity by a C corporation stockholder, would the negotiated selling price be greater than or less than $1,285?[7]

   Based on Exhibit 1, we know that the C corporation equity buyer would not be able to realize an inside basis increase of $825. Accordingly, the buyer of a C or S corporation equity interest would realize a substantially reduced tax benefit. This would likely result in a lower offer by the buyer.

   The seller would receive capital gains treatment for 100 percent of the gain on sale, instead of capital gains treatment on $750 (profit on sale of property, equipment, and goodwill), and ordinary income treatment of $75 (profit [loss] on sale of accounts receivable and inventory). Thus, the after-tax proceeds from sale of this ownership interest would be greater.

   This result would provide the seller with more flexibility to *lower* the selling price and still receive an acceptable after-tax return on sale.

2. If the transaction involved a sale of assets by a C corporation stockholder, would the negotiated selling price be greater than or less than $1,285?

   If the buyer purchased the assets of a C corporation, they would still be able to realize an inside basis increase of $825. Accordingly, the buyer of the assets of a C corporation equity interest would still realize the same tax benefit that they would realize by purchasing the assets or equity of a partnership.

   The seller would be adversely affected. The C corporation would realize an ordinary gain/capital gain on sale of the difference between the tax basis and fair-market value of all assets, and would then pay a second level of taxation on the liquidating dividend

5 This assumes that an IRC 338 election is not made. This election treats a stock purchase as an asset purchase.

6 Assuming no depreciation is recaptured as ordinary income.

7 This discussion also applies to a sale of equity by an S corporation stockholder.

**EXHIBIT 2**

XYZ Company, LLC
Balance Sheet
Date of Sale

| | TAX BASIS | FAIR MARKET VALUE |
|---|---|---|
| **Assets** | | |
| Current assets | | |
| Cash | $20 | 20 |
| Accounts receivable | 350 | 325 |
| Inventory | 300 | 400 |
| Prepaid expenses | 20 | 20 |
| | 690 | 765 |
| Property & equipment | 200 | 500 |
| Goodwill | 0 | 450 |
| Total assets | $890 | $1,715 |
| **Liabilities and Members' Equity** | | |
| Current liabilities | | |
| Accounts payable and accrued expenses | $400 | $400 |
| Notes payable | 30 | 30 |
| | 430 | 430 |
| Members' equity | 460 | 1,285 |
| Total liabilities and members' equity | $890 | $1,715 |

distribution. Thus, the after-tax proceeds from a sale of assets would be substantially less.

This result would require the seller to have an increased selling price to achieve the same after-tax return on sale.

## CONCLUSION

Transaction databases include sales of assets and equity by C corporations, S corporations, partnerships, limited liability companies, and sole proprietorships. The sellers' after-tax proceeds and the buyers' after-tax cost in these transactions are substantially impacted by sellers' entity form and whether assets or equity are sold. Selling prices are often modified due to these factors. Accordingly, the valuation analyst must take into consideration the tax savings component of each transaction's selling price in order to avoid over or understating the pricing multiples inferred by the transactions. For these reasons, when using guideline transaction databases, it is imperative to sort the transactions to separately address the stock versus asset sales provided and to sort the transactions by entity type (C corporation versus S corporation versus LLC/Partnerships) in order to properly identify the distinction in the price multiples based on these tax consequences. VE

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