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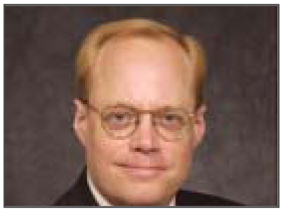

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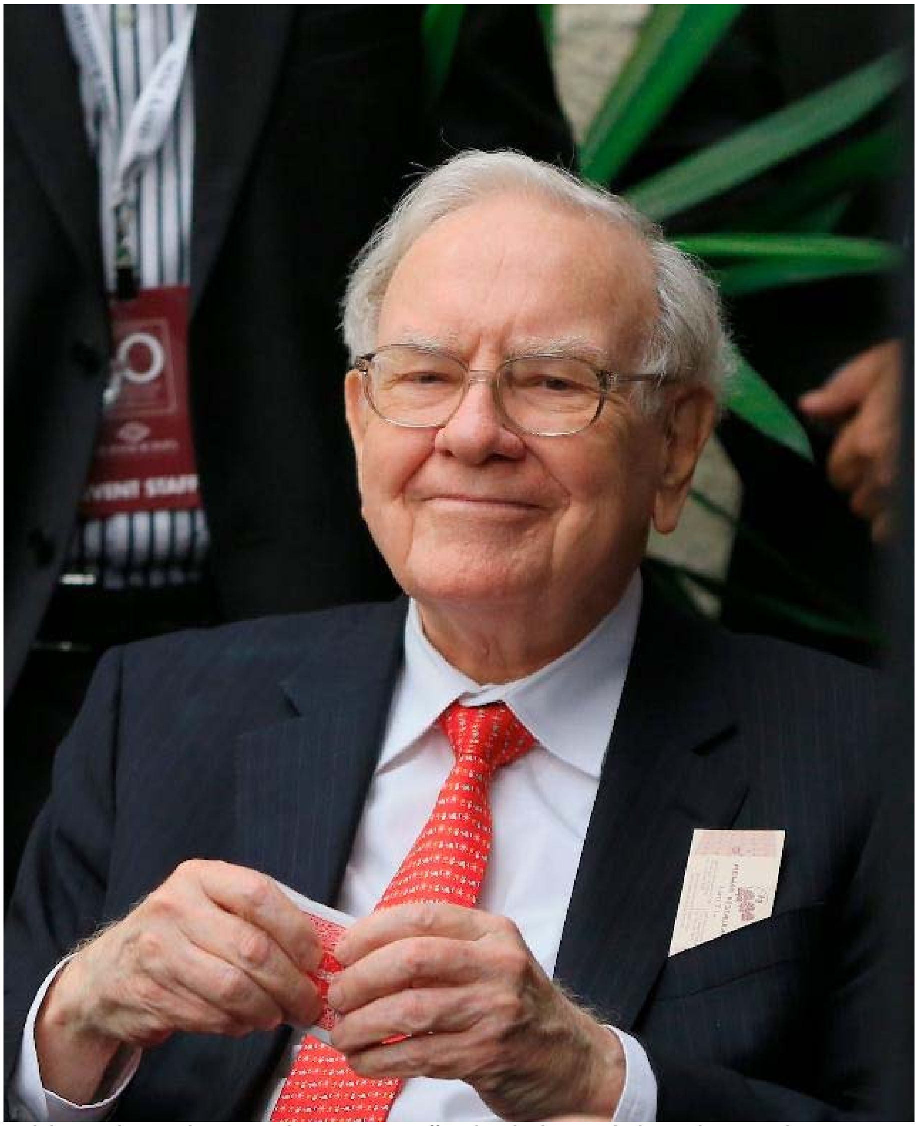
Who Pays Tax On Business Sale? Ask Warren Buffett

The sale of a business is usually a big event in the owner's life. Many work for decades or a lifetime before selling. Others build and sell multiple businesses every few years. And then there are mega and serial buyers and sellers like Warren Buffett, one of the most tax savvy of all. We'll come back to Mr. Buffett.

Selling a business almost always incurs one tax, and often two. The business entity may be taxed and the shareholders or owners. You hope to limit your tax hit to one tax not two. If you are really lucky or clever, paying no tax is even better. That is possible if you are receiving stock and rolling your gain into another or reorganized company. Again, think of Mr. Buffett, who often manages to keep rolling over investment gains without triggering a tax. Earning pre-tax is always better than earning post-tax.



Berkshire Hathaway Chairman and CEO Warren Buffett plays bridge outside the Borsheims jewelry store, a Berkshire Hathaway subsidiary, in Omaha, Neb., May 3, 2015. (AP Photo/Nati Harnik)

To figure taxes, first consider if the business is a proprietorship, partnership, limited liability company (LLC) or corporation. Regardless of the form in which you conduct business, a fundamental question is whether you are selling the stock or assets of the business. If you operate in corporate form, you could sell the stock or the corporation could sell its assets.

If the business is operated as an LLC, you could sell membership interests or the LLC itself could sell its assets. If the business is a partnership (general or limited) the sale could be made by the partnership (a sale of assets). Alternatively, the partners could sell their partnership interests. You might think all these avenues lead to the same place.

Actually, if you sell corporate stock, you change who owns the company, but the company is still in place and still owns its assets. The same is true if you sell a partnership interest or LLC membership interest. Even if all the owners sell their interests, the entity still owns the assets. To see the tax differences between these mechanical variations, you must follow the money.

If a partnership, LLC or corporation sells assets, the purchase price is paid to the entity, which may or may not distribute the sales proceeds to the owners. Regardless, the sale will have tax effects. To assess it, you need to know the tax basis of the entity's assets. The tax basis is the company's purchase price for the assets, less accumulated depreciation, plus certain adjustments.

- Example: A company sells its assets for $5 million. To determine taxes, you need to know the business' basis in these assets. If its basis is $2 million, there's a $3 million gain. If its basis is $6 million, there's a $1 million loss. Sometimes this kind of basis is called "inside" basis, meaning the tax basis inside the entity.

Depending on the type of business entity, this gain may be taxed to the entity or to its owners. For example, if a C corporation sells its assets for $5 million with a $2 million basis, that $3 million gain will be taxed to the corporation at up to 35%. That will leave only about $3,905,000 to distribute to shareholders.

If an LLC or partnership sells assets for $5 million at a $3 million gain, there is no tax at the entity level. The full $5 million can pass through to the owners who pay their share of the $3 million gain. If you think C corporation treatment is better because the entity pays the tax, think again. After all, when shareholders of a C corporation receive distributions from the corporation, they must *also* pay tax at their individual rates. That is a second tax.

Of the $3,905,000 distributed to them, how much tax they pay depends on their basis in their shares and other variables. But they pay two levels of tax. The partners of a partnership or members of an LLC pay only one level of tax. So how does all this apply to Warren Buffett?

More than most other examples, Mr. Buffett is tax savvy, often charting Berkshire Hathaway through deals that are tax free in whole or in part.

Shrewd business deals that deftly avoid taxes are a kind of trademark for the billionaire. For example, how about Berkshire turning over $4.7 billion in Procter & Gamble stock in exchange for its Duracell battery business. The latter gets a $1.7 billion cash infusion.

Normally, selling stock is taxed, but this deal sold without selling. The tax savings were probably over $1 billion. Then there was the early 2014 deal in which Berkshire swapped shares in Phillips 66 in exchange for its pipeline-flow business. These are exchanges of shares structured as a tax-free reorganizations. Mr. Buffett deftly sidesteps taxes, and yet also manages to avoid flack for doing deals that seem to contradict his “raise my taxes” mantra.

For example, Burger King’s takeover of Canadian Tim Hortons Inc. was sweetened by Mr. Buffett, who agreed to help finance it. A lower corporate tax rate in Canada was clearly attractive. Mr. Buffett saves taxes personally too. For example, he usually makes donations with appreciated stock to the Gates Foundation. Why not donate in cash? By using highly appreciated stock, he can claim a tax deduction based on the current fair market value of the stock. Yet he never has to pay the income tax on his big gain.

Mr. Buffett plans transactions efficiently to cut taxes to the bone, arranging deals that are tax-efficient. When you consider that many small business sales involve paying one or even two layers of tax exceeding 50%, many a small business could learn something from Mr. Buffett’s example.

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