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Tax Considerations in the Sale of Vacation Rental Management Companies

- Tax Planning
- Estate Planning
- Corporate Planning

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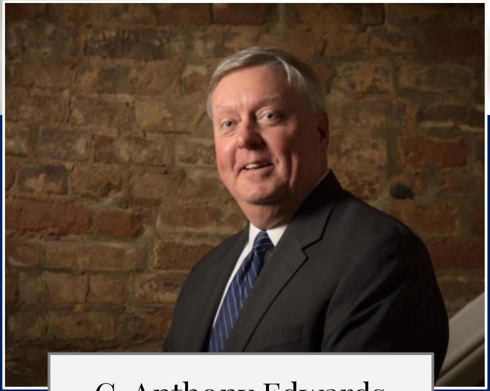

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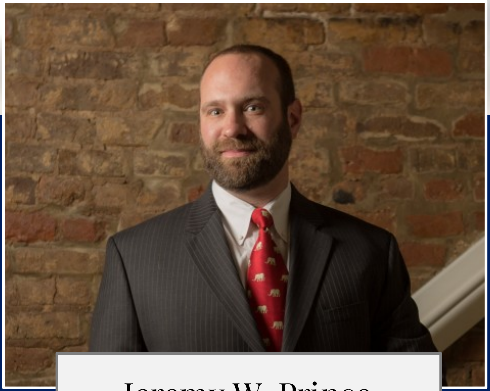

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Vacation Rental Management Industry

- Rental Managers have flourished as economic conditions improve
- Many company owners nearing retirement age and researching exit strategies
- Maximize profit by:
  - Selling while the company is doing well
  - Proper tax planning
  - Strategic transaction planning
  - Transaction negotiation

Types of Operating Entities

- Sole Proprietorship
  - General Attributes
    - One (1) owner & no employees
    - May be a single member LLC for federal tax purposes (disregarded entity)
    - Full liability for business
  - Sale Considerations
    - Essentially the sale of assets that sole proprietor uses in the business
    - Capital gain on capital assets
    - Sale of inventory at ordinary income rates
    - Flow through to personal return

Type of Operating Entities

- Partnership
  - General Attributes
    - Two (2) or more business owners
    - Partnership agreement ~ Oral or Written
    - Flow-through entity
    - Must file informational return
    - Full liability for business
  - Sale Considerations
    - Substantially similar to Sole Proprietorship

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Type of Operating Entities

- Limited Liability Company
  - General Attributes
    - Generally conducted as a partnership with some limitation on liability
    - Members rather than partners or shareholders
  - Sale Considerations
    - Basis in Units ~ Often in near constant flux
      - Members pay tax on income
      - Distributions
      - Capital contributions
    - Maximum capital gain rates can vary

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Type of Operating Entities

- Corporations
  - General Attributes
    - Most difficult to form
    - Most annual requirements
  - Sale Considerations
    - Stock Sale versus Assets Sale ~ Discussed later in detail

Type of Operating Entities

- S – Corporations
  - General Attributes
    - Election to be flow-though entity
  - Sale Considerations
    - Stock Sale versus Assets Sale ~ Discussed later in detail

Stock Sale vs. Asset Sale

- Stock Sale
  - Generally preferred by Seller & avoided by Buyer
  - Generally simplified transaction structure
  - Liability issues
    - Potential for Buyer to be subject to pre-sale liabilities & Seller be discharged of
      - Warranties & Tax obligations
    - Buyer to address additional potential liability
      - Representations & warranties ~ Negotiated by parties
      - Indemnification agreement ~ Buyer generally want longer time frame for indemnification & higher indemnity cap
        - Typically a substantial area of negotiation between the Buyer & Seller
      - Installment payments
      - Consulting arrangement with Seller

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Stock Sale vs. Asset Sale

- Stock Sale - continued
    - Tax Consequences
        - Advantageous to Seller
            - Capital gain rather than ordinary income
        - Basis
            - Stock = to purchase price
            - Assets – carryover basis

Stock Sale vs. Asset Sale

- Asset Sale
  - In general preferred by Buyer & avoided by Seller
  - In general more complex transaction structure
  - Liability issues
    - Seller retained liability for pre-sale liabilities
    - Buyer has greater control over liabilities assumed
    - Buyer may contractually limit liability for business obligations that come up after sale or relate to acquired assets

Stock Sale vs. Asset Sale

- Asset Sale - continued
  - Tax consequences
    - Generally preferred by Buyer
    - Basis
      - What Buyer paid
      - Higher basis
      - Less gain on sale later
      - Higher depreciation in future years

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Stock Sale vs. Asset Sale

- Asset Sale – continued
  - Types of assets for allocation
    - Capital Assets
    - Ordinary Income Assets
    - Depreciable Assets
    - Intangible Assets
      - Goodwill
      - Trademarks, et cetera
      - Covenants not to compete
  - C Corporation could be subject to double tax

§338 Overview

- Generally, an election to treat a stock sale as an asset sale
- Overview
  - Purchase a minimum of 80% of stock
  - Make election within 8 ½ month
  - If qualifying transaction then sale treated as asset sale in single transaction
- Consequences
  - Seller retains tax liabilities
  - Tax attributes disappear
  - Buyer holds assets with FMV cost basis
  - Selling shareholders recognize gain or loss on sale of stock
  - If minority shareholders retain stock, treated as sale of old stock for new stock

§338 Overview

- §338(h)(10)
  - Step up in basis of assets and only single level of corporate tax
  - Joint election
    - If made stock sale is ignored for tax purposes
    - Deemed asset sale and liquidation
    - Tax treatment to shareholders is generally consistent with sale and liquidation treatment
  - Advantageous to Buyer when cost basis exceeds carryover basis
  - Qualified stock purchase
    - 80% of stock purchased during 12 month period
    - Certain preferred stock may be excluded
    - S - Corporation – all shareholders must elect

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Purchase Price Allocations

- Application where purchase price is allocated to various assets acquired in transaction
  - Buyers generally want allocation to shorter-lived assets ~ Accelerated write-off of purchase price
- Can result in effective tax rate variation in excess of 20%
- Seller and Buyer need to reach agreement
  - Can be agreed prior to execution of contract and attached to purchase agreement as exhibit
    - Provides for clearer understanding of transaction
  - Contract can call for allocation to be done "post-closing" either by one party, typically Buyer, or both parties
    - Not advisable for Seller to leave in discretion of Buyer
- Recapture
  - Depreciated assets may result in "recapture" of past depreciation deductions

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Earnout / Contingent Payments

- Up-front payment then additional payment if certain agreed upon criteria are met
- Potential for ordinary tax rates on contingent payment resulting from imputed interest
  - Amount increases each year
- Installment sale method
  - Basis may be pushed to later years and wasted
  - Capital loss may occur in later year and be unable to be pushed back
- Criteria to result in contingent payment are generally in operating company and Seller has little to zero control in whether or not these criteria are met
  - Significant risk to Seller in leaving control to Buyer

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Conclusions

- Transaction Structure
- Purchase Price Allocation
- Strategic Planning for Transaction

Questions?

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