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Know the Score When Buying an Existing Restaurant

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Many restaurateurs get into the business by starting brand-new operations from the ground up or becoming franchisees. There are, however, those who either get their start or increase their holdings by purchasing existing shops. These can be win-win deals for all involved.

The sellers are typically owners looking to retire and/or cash out on a successful concept, and are in the position to realize value created through hard work, creativity, and skilled management. The buyers have an opportunity to take over a successful operation with a known revenue stream, an established reputation, and a base of customers. The customers continue to enjoy a favorite eatery that changes hands seamlessly.

But between making an initial offer to purchase and being handed the key to the front door, the buyer has a lot to consider. These transactions can be complex from a legal and tax perspective for all parties; however, typically it is the buyer who is the most vulnerable. The seller often controls the transaction. His attorney typically draws up the first draft of agreements, including the purchase contract, which contains warranties, representations, and indemnification language. To the unarmed buyer they might look reasonable at first blush. In fact, often there are liability and tax issues that the buyer might overlook, unless he involves a competent transactional attorney and tax consultant in the negotiation and drafting process to protect his interests.

If you are contemplating the purchase of an existing restaurant, we hope that this article provides an awareness of some of the issues that face a buyer of a business, and helps you have more productive conversations with your lawyer and tax adviser. In particular, the potential tax ramifications of these transactions can be mind-numbing, unless you have a particular interest in tax and transactional law. However, we also believe that the more you understand about your transactions, the more confident you will be in the process. We've tried to simplify some of the key issues as much as possible.

'Asset' Versus 'Entity' Purchase

Prospective purchasers of existing businesses face the critical question of whether to purchase just the assets of a business (an "asset purchase"), or whether to purchase the actual business entity itself (an "entity purchase").

In an asset purchase — just as it sounds — the buyer purchases the business's equipment, inventory, rights to use its name, etc. Most often, the buyer creates a new entity, typically, an

S corporation (S-Corp) or limited liability company (LLC) to operate the business going forward. In an entity purchase, the buyer purchases the business entity itself by acquiring all selling corporation's or LLC's shares.

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In most cases, sellers prefer to sell the entire entity, while buyers prefer to purchase the assets only. From the seller's standpoint, the potential tax benefit of an entity sale is that the profits are considered 100 percent capital gains (assuming that he's not selling at a loss.) Capital gains are taxed at a lower rate than ordinary gains. On the other hand, if the seller sells just the assets, some of the gain may be ordinary, and some may be capital, depending on the assets. Not every asset's sale proceeds are eligible to be taxed as capital gains or loss. In any event, for the seller, tax planning in an asset sale is usually more complex than in an entity sale.

From the buyer's perspective, an asset purchase is preferable, since in an entity purchase, he might assume the liabilities of the previous owner, and could be at a tax disadvantage, for the reasons we discuss below in detail. In short, it's important that both buyer and seller understand these issues prior to entering negotiations.

For Example

Joe's Diner, LLC, has been placed on the market through a business sales broker. William "Will" Cook wants to be a restaurant owner, and he likes the location, name, and concept of Joe's Diner. As part of his initial due diligence, he learns that Joe's Diner, LLC, is a profitable enterprise.

William intends to create a new company, Cook Enterprises, LLC, to purchase the assets of Joe's Diner, including all rights to the restaurant's name, rather than purchasing Joe's Diner, LLC, itself. The two owners of Joe's Diner, LLC, (i.e., the individuals who hold all of the membership interests in the company) want to simplify the transaction. They suggest that William purchase all the shares of Joe's Diner, LLC, (i.e., an entity purchase), and even sweeten the deal to encourage William to take this path.

> "As you have probably found, few restaurants are owned as proprietorships. Instead, they are more likely to be organized as corporations or LLCs, to shield the owner(s) from liability."

Joe's Diner, LLC, owns all of the assets of the restaurant, including rights to the name. William thinks, "Why just purchase the assets of the company when it seems that buying the entire company would be a more seamless transaction? Anyway, I want to start running this place ASAP!"

William refers the matter to his attorney and tax adviser, who explain the pros and cons of each of these two methods. Generally speaking, most buyers prefer an asset purchase over an entity purchase for the following reasons:

- William can pick and choose among the seller's assets, buying whatever he wants, and does not have to purchase all of the seller's assets.
- William would get a "full cost" basis for the assets purchased. This means he can begin taking full depreciation on all of the assets purchased, and can dispose of these assets without having to pay tax on any untaxed gain accumulated while they were held by Joe's Diner, LLC.
- William does not become responsible for Joe's Diner, LLC, as an entity. He doesn't have to file tax returns for Joe's Diner, LLC, as an entity, liquidate the entity, etc. He just owns the assets. The future of Joe's Diner, LLC, after the sale is not his problem.
- William may be able to avoid exposure for the liabilities of Joe's Diner, LLC, by purchasing just the assets of the company (instead of purchasing the company itself). When you purchase the company itself, you very often will "step into the shoes" of the former owners, becoming liable for the seller's liabilities. If Joe's Diner, LLC, is facing pending litigation, for example, William could inherit it by purchasing the entity. That is why it is so important for a buyer of an entity to demand sufficient warranties and representations of all known liabilities, and seek broad indemnification for such in the purchase agreement. Note that a buyer can also acquire responsibility for the seller's

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liabilities by buying just the assets of the business (especially where he buys all or most of the business's assets), but, without going into great detail, there is certainly opportunity to avoid this result in an asset purchase rather than an entity purchase.

By contrast, there are certainly reasons why Will might prefer to buy the seller as an entity instead of the seller's assets. These include:

- If William wants to continue operating the business as it is, buying Joe's Diner, LLC, the entity, itself makes for a more seamless transition for the buyer and is less noticeable to the customers of the business that new ownership is in place.
- William would not have to form a new entity (i.e., Cook Enterprises, LLC), get new taxpayer ID numbers, bank accounts, property tax listings, etc.
- William might not have to renegotiate contracts with suppliers, vendors, etc., of Joe's Diner, LLC. They might continue to do business with Joe's Diner, as if nothing has changed.

A Taxing Decision

As suggested above, of the advantages to the asset purchase from the buyer's standpoint, probably the biggest one pertains to taxes: The buyer would receive "full cost basis" for assets purchased. This is often the major influencing factor for the buyer.

Here's a simple scenario to illustrate when purchasing the assets of the business would provide a more favorable tax outcome for the buyer. Imagine that a single shareholder owns all of the stock of The Restaurant Inc. (TR Inc.), a corporation in which he has invested $100,000. In accounting terms, the tax "basis" in his stock is $100,000. ("Basis" refers to the original cost of an asset less depreciation. The resulting amount is used to determine gains or losses for tax purposes.) Depending on how much time has passed since TR Inc. purchased the assets, they might be fully depreciated. We would say that the shareholder's "outside basis" for his stock is $100,000, but that the corporation's "inside basis" for its assets is $0.

If this shareholder wanted to "liquidate" TR Inc., (i.e., sell off all its assets) he would be subject to tax on $100,000, which represents the $100,000 value of the corporation's assets, less the corporation's "inside" basis of $0. This would be true whether the corporation sold its assets for cash and then dissolved itself, or whether the corporation dissolved and then all of its assets were distributed to the shareholder.

If a buyer purchased TR Inc. as an entity (i.e., purchased all of the stock of the corporation), he would "step into the shoes" of the selling shareholder, and would be subject to this same tax result. So if the buyer later liquidated the corporation, the buyer would be subject to tax on this same $100,000 amount of gain. The more immediate, and perhaps significant, tax consequences to the buyer is that he is unable to depreciate the assets. Again, he steps into the shoes of the seller, who has already fully depreciated the assets.

But, if the buyer bought the assets of the corporation instead (rather than purchase the corporation as an entity) for $100,000, then he would have a full $100,000 basis in these assets and would not be subject to any taxable gain. He could form a new corporation and transfer these assets to that corporation. In tax terms, the new entity's inside basis and the buyer's outside basis in its stock would now both be $100,000. As noted in the previous example regarding Joe's Diner, LLC, the buyer can begin taking full depreciation on all of the assets purchased, and can dispose of these assets without having to pay tax on any untaxed gain accumulated while he held them. The immediate and future tax savings to the buyer realized by purchasing the business's assets, rather than the entity itself, could be significant.

But Sometimes Asset Versus Entity is a Nonissue

Here is where it gets a little confusing. In some cases, the "asset versus entity" question is a nonissue for tax purposes. For example, let's say the business you're purchasing is a proprietorship. The owner is a person who owns all the assets of the business and simply files a Schedule C on his tax return. Since a proprietorship is not deemed to be a separate entity from its owner, unlike a corporation or LLC, the purchase of a proprietorship is treated as an asset purchase for tax purposes, by default. Simply put, there is no entity to purchase in such a case.

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As you have probably found, few restaurants are owned as proprietorships. Instead, [illegible] more likely to be organized as corporations or LLCs, to shield the owner(s) from liability. Still, this scenario provides a useful illustration because a similar result could occur when the buyer is purchasing a single-owner LLC, in which the owner is an individual (as opposed to a single-owner LLC that is, in turn, owned not by an individual person but by another LLC or a corporation). That's because the IRS generally treats a single-owner LLC as a "disregarded entity" for tax purposes, as if it did not exist separately from its owner. So, if the one owner is an individual, and you disregard the LLC, then you are left with a sole proprietorship, at least for tax purposes. Thus, as logic would follow (or at least IRS logic), even if you purchased the LLC itself (i.e., its shares, rather than its assets), the purchase is treated as an asset purchase, taxwise, by default. (See "Tax Talk: Pass-through? Disregarded? Huh?" below.) Why should you care? From a practical standpoint, you might be able to gain certain benefits of an entity purchase and the tax benefits of an asset purchase, by purchasing the entity.

But what if the business you're buying is a corporation with one owner who is an individual? Here's a situation in which LLCs and corporations differ taxwise: The IRS never treats a corporation as a disregarded entity for tax purposes, not even a single-individual shareholder S-Corp. As far as the IRS is concerned, a corporation is always "separate" from its owner shareholders, and is never automatically an asset purchase, as it would be in the purchase of a single, individual-owned LLC. So when purchasing a corporation, regardless of the number of shareholders, you will probably need to structure the deal as an asset purchase to get full basis of the assets.

Of course, many restaurant business corporations and LLCs are owned not by individuals, but by other corporations and LLCs, as subsidiaries. For example, ABC, LLC, a holding company, might own XYZ, LLC, a restaurant business. Therefore, when purchasing a restaurant, the buyer needs to know who or what owns the target business in the transaction to determine the tax ramifications of his purchase. The organization of the owner of the business can affect the inside and outside tax bases of the seller's assets and the buyer's tax exposure, if and when the buyer decides to liquidate the business.

Buyer Be Aware

We don't expect you to curl up in front of the fireplace with a glass of wine and an abridged copy of the Internal Revenue Code; however, we hope you can see that a prospective buyer needs to bring more than a transactional attorney into the transaction to review documents. He also should employ a qualified tax professional, such as a certified public accountant, both to examine the books and tax records of the selling company, and to determine if it is a disregarded entity.

Purchasing a business is the most complex and expensive transaction most individuals will encounter. Again, by enlisting the help of qualified professionals to assist with your due diligence, negotiations, and drafting, when purchasing a business, you can increase the odds that you'll avoid unpleasant surprises and disappointments after the deal is done.

Please note that no magazine article, including this one, should be considered a replacement for qualified legal and tax advice. Each transaction has specific circumstances and issues that need to be considered individually.

-- Restaurant Startup & Growth

Tax Talk: Pass-through? Disregarded? Huh?

An S corporation (S-Corp) is a "pass-through" but not a "disregarded" entity. An LLC is both a pass-through and disregarded entity. What the heck does that mean, and why should you care?

When forming and purchasing your business, you might hear your accountant and lawyer tossing around the terms "pass-through" and "disregarded" entities. Here is a primer on these tax terms to help you be more conversant in the lingo of your tax advisers, and how these

concepts affect a business purchase transaction.

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As you might know, an S-Corp elects not to be taxed as a corporation, so the corporation does not directly pay federal income tax on its earnings. Similar to a partnership, it passes its income or losses and other tax items on to its shareholders. It is a popular business form for small businesses — second, perhaps, to the LLC.

An S-Corp is a "pass-through" entity; i.e., the owners — not the corporation itself — are subject to taxation on the income of the business. An LLC is also a pass-through entity. However, an S-Corp is not a "disregarded" entity. Unlike an LLC, it is not treated by the IRS as if it does not exist. If an entity is disregarded it doesn't file a tax return. In that case, the owner (s) simply reports the entity's income and losses directly on the owner(s) return. An S corporation doesn't pay any taxes, since the income of the business passes through to the owners; however, the corporation still has to file a corporate tax return.

How does this matter in a real-world business purchase transaction? The sale of an S-Corp, even if there is only one shareholder, is the sale of a corporation, and thus the sale of an entity. If all you want are the assets, and don't want to step into the shoes of the seller, you would most likely have to structure an asset purchase.

This is different from the purchase of a single, individual-owned LLC, which is treated as a sole proprietorship for tax purposes. Because of this distinction, the buyer of a single, individual-owned LLC can purchase the entity and still receive full tax basis for the assets. If you are in the formation stage of a new company, for this reason, an LLC might be a more attractive target to purchase than an S-Corp, from a tax perspective, when you get ready to cash out. It might be something to discuss with your accountant when choosing the form of a new business entity.

Tax Talk: Steppin' Up With a 'Section 754 Election'

If you are considering purchasing a partnership or LLC with more than one owner you might hear your accountant say something about taking a "section 754 election" (referring to section 754 of the Internal Revenue Code). This federal tax provision falls under the partnership income tax regulations, and it allows the buyer to "step up" the inside basis of the assets owned by the partnership to the purchase price paid by the buyer. (To "step up" in basis means to increase the taxable basis of the property.)

So what is the practical value of this information, to you the buyer? In effect, the section 754 election can reduce the amount of taxable gain to which the buyer is subjected, by reducing the difference between the partnership's inside basis and the buyer's outside basis. Partnerships are not preferred business structures for restaurants, for the same reasons that sole proprietorships are unusual in this regard, i.e., they don't offer a liability shield for the managing owners.

Still, you should be aware of this provision, since it can be applied even if you are not purchasing a partnership. That's because most multiowner LLCs are treated as partnerships for tax purposes, and so the opportunity to apply a section 754 election would apply to the purchase of this type of entity, which is quite common in the restaurant business. In this case, this election can reduce the buyer's tax exposure. Your accountant can advise you further on this tax code provision, as it relates to your specific transaction.

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