Installment Sale Purchase Price Adjustment, Now What?

So you want to sell your business. The issue that is probably in the forefront of your mind is selling price. While there are tax implications that will definitely impact the after tax cash that you receive, something that you may not consider is what happens when the purchase price changes after the sale is complete.

Reduction of Purchase Price

Fast forward to after the sale and the buyer would like to re-negotiate the deal. You're probably thinking that getting something is better than getting nothing, so you agree to a reduction of the original purchase price. For tax purposes, you will have to recalculate your gross profit percentage and will use this percentage to calculate your gain to be reported over the remaining term of the note.

Example: Reduction of Purchase Price Impact to Seller

ABC Co sold a business to XYZ Co for $250,000 payable in 5 yearly installments. The basis of the property in ABC Co's hands was $100,000. Therefore the gross profit percentage is 60%. In year 1 ABC Co collected the first installment of $50,000. In year 2, ABC Co and XYZ Co renegotiated the selling price from $250,000 to $200,000 payable over the remaining 4 yearly installments.

Reduced Selling Price	$ 200,000
Less: Original Basis	(100,000)
Less: Renegotiation Expenses	(2,250)
Recomputed Gain on Sale	97,750
Less: Gain Previously Reported	(30,000)
Gain to Report Over Remaining Term	$ 67,750

The recomputed gross profit percentage for the remaining payments is 45.16% ($67,750/$150,000). In year 2 ABC Co receives a payment of $37,500. The portion that would be reported as a gain would be 45.16% of $37,500 or $16,935.

Same Example: Impact to Buyer

When the purchase price is reduced from $250,000 to $200,000, XYZ Co must reduce its basis in the property for depreciation purposes. Therefore XYZ Co must stop depreciating $50,000 of basis. Suppose XYZ Co had fully depreciated the purchased assets. Under the tax benefit rule, the purchase price reduction would trigger gain to the buyer for the $50,000 reduction.

Purchase Price Adjustment and Earn-Out Provision

Another way that a purchase price can be adjusted is when there is an earn-out provision written into the purchase/sale agreement. This usually occurs when a seller wants more for the business than the buyer is willing to pay based on past performance of the business. As a compromise, the buyer and the seller decide to structure an earn-out where the seller receives a certain amount based on the future performance of the company.

How this works from the Seller's Perspective:

The seller doesn't know the total amount that will be received. If a maximum amount is determined, the gross profit percentage should be calculated using that figure as the selling price. If at any time the maximum amount is reduced, then the gross profit percentage must be recalculated for the remaining payments.

Alternatively, if you do not know the maximum amount that will be received but you do know the period over which payments will be made, the basis will be allocated in one of two ways.

1) Either the basis will be allocated equally over the term; or
2) If payments will not be calculated the same way every year, such as annual payments that are a declining percentage of profits, basis will be allocated based on that component.

If insufficient payment is received to recover the basis, the basis will be carried forward into the next tax year.

From the Buyer's Perspective:

Although the seller is required to calculate the gain based on the total that could be received, the buyer will only receive basis when the payments become fixed. Additionally, no amounts treated as interest will be considered basis.

Conclusions

Both of these topics are in an installment sale situation, however, not all transactions qualify for this treatment. Additionally, there are times when it would be more beneficial to elect out of installment sale treatment. As a buyer/seller, make sure you have advisors who specialize in this area so that you can focus on completing the purchase/sale. Please call John Forrest at Sweeney Conrad 425-629-1990 if you would like to discuss this topic in more detail.