A package deal

What to do when the sale of your business and real estate are separate

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WEBSITE: To learn more about selling your business when real estate matters come into play, visit www.brouse.com.

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Business owners tired of paying rent to a landlord will often buy or construct a new facility and then create a separate limited liability company to own and manage it. The LLC can then lease space to the company, as well as to outside tenants who pay rent and provide business owners with an additional income stream.

The formula works exceptionally well when the current ownership structure is in place. However, when it comes time to either sell the business or bring in additional owners and/or stakeholders, legal difficulties can arise depending on how the transaction plays out, says David A. Lum, a Partner at Brouse McDowell.

"If the building will be leased to the new buyer, the lease will need to be updated to protect the owner and more appropriately reflect the division of responsibilities between landlord and tenant," Lum says. "Maintenance and ongoing capital repairs, as well as length of term and renewal options are often the biggest points of negotiation with the new tenant."

Smart Business spoke with Lum about how these extenuating factors can affect the sale of your business.

What are some key considerations when selling a business in which the physical space is owned by a separate LLC?

When selling both the business and the real estate, you need to make sure that all of the due diligence materials are up to date and clean. Are there any environmental issues that need to be dealt with or title issues like easements or encroachments?

Over the life cycle of a business, these issues can often develop and be overlooked because the landlord and tenant are the same. Potential buyers, and their lenders will certainly do their own research and any significant issues on this front could cause a problem with the overall deal. If you are selling the business to a third party, but they are not buying the real estate, they may want to lease it. In that case, you need to make sure that the lease is formalized.

In closely held businesses, even though the property is held in a separate entity, there is not always a formal written lease. The lease will need to be formalized and will likely be the subject of negotiations during the sale of the business. The term, rent and options are financial points that are always negotiated and maintenance responsibilities also become an issue for discussion.

As the operating entity, the tenant most likely handled all of the maintenance of the property, including capital expenditures. After the sale, the buyer of the business as the tenant in the building will likely require a more customary allocation of maintenance responsibilities. As just a tenant, they will not want to incur costs on capital expenditures toward the building.

How does the structure of the lease affect your options?

If the ownership of the business is the same as the ownership of the real estate, then the lease can always be amended or modified to address any issues with the buyer. However, the situation can be further complicated if the ownership of the business is not identical to the ownership of the real estate — perhaps one portion of a family owns the real estate while another portion owns the business and there is a lease.

While the real estate owner and business owner are related, they have substantially different economic interests to be dealt with in the sale of the business. The value of the business will be affected by the rental rate and other lease terms. This can be further complicated if the buyer of the business does not want to purchase or lease the real estate — where they intend to move or consolidate the business to another location. The business owners may sell the business and capture the value, while the real estate owners (without a strong lease obligation), may be left with an empty building.

How might a 1031 exchange be helpful?

Tax planning is important to consider in any sale. Depending upon the status of the property, there may be a significant gain on the sale of the real estate. A 1031 like-kind exchange may allow the seller to defer tax on the potential gain, but there are significant preparations and qualifications that must be met to accomplish the exchange. When contemplating a sale of the business and real estate, you should involve your lawyer and your accountant to make sure that the sale is structured appropriately to accomplish your goals. ●