Buying and Selling a Business–Tax Considerations

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Introduction

- Buying or selling a business is a complex transaction. There are many tax variables to consider, such as:
  - Structure of transaction (i.e. asset sale versus a stock sale)
  - Goals of both Buyer and Seller
  - Types of entities involved as buyer and seller (corporations, partnerships, LLCs, individuals, etc.)
  - Unwanted assets
  - Hidden liabilities

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Structure of Transaction

- An existing business can be acquired in two basic ways:
  - The purchaser can buy
  - ➢ the **Assets** of the business; or
  - ➢ the **Stock/Ownership Interests** (i.e. the stock of a corporation, a membership interest in an LLC, etc.).

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Critical factors in determining transaction's structure

- Amount of tax paid by the seller (character & double tax).
- Assumption of the business liabilities, including those not yet identified.
- Purchaser's ability to step up the basis of business assets (generating a tax benefit when the assets are sold, depreciated, or amortized).
- Ability to obtain tax related benefits, such as NOL carryovers.
- Purchaser's ability to amortize intangibles, such as customer lists, contracts, or know-how.

What the Seller Wants

- Seller's main concerns when a business is sold are minimizing tax on any realized gain and being insulated from the business's liabilities

What the Seller Wants

- If the business is a C corporation, the seller often has a strong preference for selling stock rather than assets because—
  - Avoidance of potential double taxation which could occur with asset sale;
  - The seller's gain is almost always capital gain, qualifying for preferential tax rate (currently 20% for 2013); and
  - Liabilities (both known and unknown) associated with the company remain with the stock

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What the Seller Wants

- If the business is a partnership, LLC, or S corporation:
  - The negative tax consequences of selling assets (rather than the entity) are usually less severe, since the gain on asset sale is passed through to the owners resulting in a single layer of tax.
  - Hidden Issues –
    - Hot Assets in a partnership
    - Ordinary Income Assets in an S Corporation
    - State Tax for Nonresident owners

What the Buyer Wants

- **Generally, buyers prefer to acquire assets rather than stock.**
    - Acquiring assets protects the buyer from assuming the seller's liabilities (especially contingent or unknown liabilities) which is what happens when stock is purchased.
    - An asset purchase also allows the buyer to acquire only the assets it wants.
    - An asset purchase allows the purchaser to step up the basis of the acquired assets to FMV.

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Taxable Stock Purchase

Seller's Tax Consequences

- The seller realizes capital gain or loss equal to the difference between the sales proceeds and tax basis in the stock.
- Assuming the stock was owned for over 12 months, any gain would be taxed at favorable long-term capital gain rates (i.e. 20% under current law.)
- Any value assigned to a non compete is taxed as ordinary income

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Taxable Stock Purchase

Buyer's Tax Consequences

- Buyer obtains basis equal to its purchase price.
- Basis is not recovered until stock is sold or liquidated.
- No adjustment is made to the basis of the assets in the corporation (i.e. carryover basis).
- Tax accounting method changes may have negative consequences to buyer

Taxable Stock Purchase

Buyer's Tax Consequences (cont.)

- The corporation's tax attributes (i.e. NOL, capital loss, and credit carryforwards) remain with the buyer and are available to offset income generated after the sale.
  - However, IRC Sec. 382 may limit the use of these attributes after an ownership change

Taxable Stock Purchase

Purchasing Stock with a Sec. 338 Election

- When a buyer purchases stock, a Sec. 338 election treats the purchaser as if assets were purchased for tax purposes.

- **Why would a Buyer want a §338 election?**
  - The Buyer is purchasing stock but would like a step-up in the basis of the Target's assets.

Taxable Asset Purchase

- Although a purchaser often would prefer to purchase business assets for reasons discussed earlier (e.g., limited liability exposure, basis step-up to FMV, ability to purchase only desired assets, and the opportunity to renegotiate or terminate existing unfavorable contracts), the tax cost to the seller is often prohibitive.

Taxable Asset Purchase

- In certain situations, however, an asset purchase may be the appropriate structure for a C corporation.
- For example, if the selling corporation has NOLs to offset the gain on the asset sale, or the purchaser's step-up will be allocated to assets that are sold or depreciated very quickly (so that the purchaser is willing to increase the purchase price by an amount equal or almost equal to the seller's tax cost).

Taxable Asset Purchase

Seller's Tax Consequences

- The selling entity allocates the sales price to each asset sold using the residual method described in IRC Sec. 1060.
- Potential double taxation resulting from 1) Sale of Assets and 2) Liquidating Distribution

Taxable Asset Purchase

Seller's Tax Consequences (cont.)

- If the business is an S corporation, the gain on the asset sale is generally taxed only once, since the gain increases the owner's basis in the entity (reducing any tax on a future liquidating distribution).

Taxable Asset Purchase

Purchaser's Tax Consequences

- Buyer's purchase price is allocated to all the acquired assets using the residual method described in IRC Sec. 1060.
- Any purchase price in excess of the acquired assets' FMV is allocated to goodwill and amortized over 15 years.
- Buyer is not entitled to any of the acquired entity's tax attributes (e.g., NOL, credit carryforwards, etc.).

Purchasing Stock with a Sec. 338 Election

- 2 types of Sec. 338 elections
  - Section 338(g) ("Regular" Sec. 338 Election)
  - Section 338(h)(10) Election

Purchasing Stock with a Sec. 338 Election

- For either election:
  - The Purchaser must be a corporation.
  - During a 12 month period, the purchasing corporation must purchase 80% or more of the vote and value of the Target stock.

Regular Sec. 338 Election

1. T's selling shareholders are treated for tax purposes as having sold their T stock to P.
2. T is treated as having sold all of its assets at FMV to a new corporation ("New T").
3. Old T recognizes and is taxed on the full gain and loss on the deemed sale of its assets.
   - Thus, it is advantageous to make a Code §338 election for T only in certain limited circumstances (i.e., T has a large NOL).
4. New T is treated as purchasing old T's assets.
5. New T generally takes a basis for old T's assets equal to the price P paid for T's stock.
6. Old T's tax attributes (i.e. NOL and tax credit C/Fs) disappear.

Regular Sec. 338 Election

- **Potential Double Taxation**
  - Because of the potential tax liability at the target corporation level (resulting from the deemed sale of the target's assets) and the potential additional tax liability at the selling shareholder level, a regular Section 338 election generally makes sense only in limited circumstances.

Regular Sec. 338 Election

- When this election makes sense:
  - Target has unused NOL, capital loss, or tax credit carryovers that will offset the gains and tax recognized as a result of the election;
  - The use of target tax attributes after the stock purchase will be limited by IRC Secs. 382-384 if a Section 338 election is not made;
  - Target holds depreciable property (basis exceeds FMV) such that sale generates loss that can be carried back to an income year

Section 338(h)(10) Election

- An IRC Sec. 338(h)(10) election is a special election that can be made when:

  1. The target corporation is a member of a consolidated return group or;
  2. When the stock of an S corporation is purchased by another corporation.

Section 338(h)(10) Election

- The effect of this election is to treat the acquired corporation as if it sold all its assets and then distributed the proceeds to its shareholders in complete liquidation.

- The corporation is taxed on the deemed sale of its assets, but double taxation is avoided because the target is deemed to be liquidated into its parent corporation tax-free under IRC Sec. 332 if a member of a consolidated group or it is an S Corp that does not pay corporate level taxes.

Advantages of Sec. 338 Elections over Direct Asset Purchases

- A direct asset purchase of the target's assets followed by a liquidation of the target through distributing the sales proceeds to its shareholders may achieve approximately the same tax results as a Sec. 338 election.
- However…

Advantages of Sec. 338 Elections over Direct Asset Purchases

1. The target may have many assets, making the transfers of title after a direct asset acquisition expensive and time-consuming. Also, contracts may not be transferable in an asset purchase.

2. A Sec. 338 election, with the resulting step-up in the basis of corporate assets, can be made after acquiring 80% of the target's stock. Thus, in effect, 100% of the assets can be stepped up by buying only 80% of the target's stock.

Section 338 Elections

- <u>**Caution**</u>: Note that a disadvantage of either type of Section 338 election is that the underlying transaction is still treated as a stock purchase for legal purposes. Therefore, the target corporation's liabilities, including any unknown, undisclosed, or contingent liabilities, remain intact.

Other Considerations

- State Tax
  - Impact of asset purchase or 338(h)(10) election could result in additional state tax for shareholders
- International
  - Stock acquisition acquires the international structure, which could or could not be tax efficient
  - Dual Consolidated Losses

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Finding Common Ground

- While it may seem that the interests of buyer and seller are always opposed, the desire to complete the transaction usually provides motivation to strike a deal that satisfies everyone.

Finding Common Ground

- Several options are available for finding common ground…
  - The seller could sell assets and demand a higher selling price.
  - The seller could sell stock and accept a lower sales price.
  - The seller could indemnify the buyer with respect to certain liabilities.
  - The seller could agree to escrow a certain amount of funds to cover future liabilities.

Selling or Buying Partnership Interests vs. Assets

- When the business is operated as a partnership, there is little tax difference between selling assets and selling an interest in the partnership
  - This is because when partnership interests are sold, the sale triggers a liquidation of the partnership assets into the hands of the buyer.

Selling or Buying Partnership Interests vs. Assets

- In either case, gains or losses are passed through to the partners where they retain their character as capital or ordinary.

**** No Double Taxation*

Q & A Session…

Thank you!

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