Tax Strategies for Selling Your Company

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The tax consequences of an asset sale by an entity can be very different than the consequences of a sale of the outstanding equity interests in the entity, and the use of buyer equity interests as acquisition currency may produce very different tax consequences than the use of cash or other property. This article explores certain of those differences and sets forth related strategies for maximizing the seller's after-tax cash flow from a sale transaction.

Taxes on the Sale of a Business

The tax law presumes that gain or loss results upon the sale or exchange of property. This gain or loss must be reported on a tax return, unless a specific exception set forth in the Internal Revenue Code (the "*Code*") or the Treasury Department's income tax regulations provide otherwise.

When a transaction is taxable under applicable principles of income tax law, the seller's taxable gain is determined by the following formula: the "*amount realized*" over the "*adjusted tax basis*" of the assets sold equals "*taxable gain*." If the adjusted tax basis exceeds the amount realized, the seller has a "*tax loss*." The amount realized is the amount paid by the buyer, including any debt assumed by the buyer. The adjusted tax basis of each asset sold is generally the amount originally paid for the asset, plus amounts expended to improve the asset (which were not deducted when paid), less depreciation or amortization deductions (if any) previously allowable with respect to the asset. Taxable gain is generally decreased, and a tax loss is generally increased, by transactional costs and expenses paid by the seller.

Ordinary vs. Capital Gains and Losses

The character of a taxable gain or loss can be vital in determining the amount of tax due upon the sale of corporate assets. Gain can be classified as ordinary income or capital gain. Gain upon the sale of assets that are characterized by the Code as "*capital*" is capital gain. The sale of a capital asset held for more than one year creates long-term capital gain and is, for sellers other than so-called "*C corporations*" (i.e., corporations for which an election to be subject to subchapter S of the Code has not been made), taxed at a much lower tax rate. Currently, for federal purposes, this rate is about half of that applicable to ordinary income. If a taxable gain from the exchange of a capital asset held for less than one year, it is a short-term capital gain, which is generally taxed like ordinary income.

C corporations are subject to identical federal income tax rates on their ordinary and capital gain income, so the character of a C corporation's gain is often irrelevant. However, the capital losses of C corporations still may only be offset against capital gains, and such losses are also subject to far more restrictive carry-back and carry-forward provisions than are ordinary losses. So, if a C corporation has excess capital losses during a taxable year (or capital losses which have been carried forward from an earlier year), the corporation may prefer capital gains over ordinary income, because the excess capital losses may be used to offset the capital gains (but could not be used to offset ordinary income).

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It is usually very important (and, in most instances, required) for the seller and buyer to agree upon an allocation of the sales price among the assets being sold, as such will determine the character of the gain recognized by the seller and also will determine the amount of sales, use and other transfer tax liabilities arising from the sale (which are usually imposed on the seller by law, but may be passed on to the buyer via contract). Although tax authorities are generally free to challenge such an allocation, they usually will respect an allocation agreed upon by the seller and buyer and negotiated at arm's-length. For sellers that are not C corporations, how the sales price is allocated can save or cost substantial amounts of tax.

Tax Consequences Arising From Sale of Assets

In an asset sale, the buyer agrees to purchase all or a select group of assets from the seller, usually subject to either all or certain liabilities. If both the acquirer and the selling entity are corporations and the sales price consists or includes stock of the buyer, the transaction may constitute a tax-free "*reorganization*" (discussed below). Otherwise, the selling entity will recognize taxable gain or tax loss with respect to the sale of each asset equal to the difference between the amount realized for each asset sold and its adjusted tax basis.

A selling entity that is a C corporation will pay federal and state income taxes on the net taxable gain from the asset sale. If the corporation then wants to distribute the proceeds to its shareholders, each shareholder will then be taxed on the amount distributed to him or her. If the distribution is a dividend, the amounts distributed to the shareholders will be taxable as such (subject, in the case of C corporation shareholders, to a special exclusion known as the "*dividends received deduction*"). If the distribution is in liquidation of the distributing corporation, each shareholder will recognize taxable gain equal to the difference between the amount distributed to it over its adjusted tax basis in his or her stock in the distributing corporation. To avoid this "*double-tax problem*," and also to minimize or avoid sales, use and other transfer taxes, a C corporation should avoid asset sales. Instead, the owners should seek to sell their stock.

But there is a potential problem with a stock acquisition for the buyer. If the buyer buys the corporation's assets, virtually the entire purchase price can be deducted over time through depreciation and amortization deductions with the resulting tax savings essentially paying for a portion of the purchase price (usually a very material portion of the purchase price). If, on the other hand, the outstanding stock of the corporation (a non-depreciable and non-amortizable asset) is bought, the buyer will be limited to deducting depreciation and amortization based on the adjusted tax basis in the corporation's assets immediately prior to the acquisition (in other words, any premium paid over book value cannot be deducted for income tax purposes). The foregone deductions essentially mean that the government will fund less of the buyer's purchase price through future tax savings, which often means that the buyer will want to pay less for the stock of the corporation than it would want to pay for the corporation's assets.

Where the seller is an "*S corporation*" (which is taxed similarly to a partnership in that it generally doesn't pay income taxes), or is a subsidiary of another corporation, the buyer and seller may jointly elect to treat a purchase and sale of stock as an asset purchase and sale for income tax purposes. The benefit of this is that the buyer will obtain an increase in the adjusted tax basis of the assets of the corporation and may be willing to pay an increased price due to the increased tax savings available to the buyer in the future. Also, the making of this election is not taken into account for sales, use and other transfer tax purposes, so those taxes may be largely avoided.

Tax Consequences Arising From Sale of Equity Interests

In a sale of equity interests, the buyer agrees to purchase all or a portion of the outstanding equity interests in an entity from one or more of its owners. If both the acquirer and the entity to be sold are corporations, and the sales price is or includes the buyer's stock, the transaction may be a tax-free reorganization (discussed below). Otherwise, each seller will recognize taxable gain or tax loss equal to the difference between the amount realized by it from the buyer and its adjusted tax basis in the interests sold. If

gain is recognized, some or all of the gain may often be deferred through the use of seller financing, which can increase the seller's after-tax yield because the seller is investing pre-tax instead of after-tax money at the interest rate provided in financing documents, but there can be a toll charge for this deferral in certain larger transactions.

Tax-Free Corporate "Reorganizations"

The Code sets forth a number of tax-free transaction structures known as "*reorganizations*" that are available where both the seller and the buyer are corporations (either C or S corporations) To qualify as a reorganization, a transaction must meet certain requirements, which vary greatly depending on the form of the transaction. If all applicable requirements for a reorganization are met, shareholders of the acquired corporation are not taxed on the portion of the sales price that consists of shares of the acquiring corporation. Of course, the threshold issue for the sellers will be whether they are willing to take stock of the buyer and, if so, how long they would be willing or required to keep it. If certain or all of the sellers are concerned about taking stock in the buyer due to investment or market risk, consider (i) requiring that the stock be freely tradable upon receipt, so that concerned sellers may sell all or a portion of the shares received by them immediately in open market transactions, (ii) negotiating price protection from the buyer, so that, if the buyer's stock value goes down below a stated threshold over a stated period of time, the sellers would get additional consideration, and/or (iii) seeking an investment hedge arrangement from an investment bank. All of these arrangements may be structured in a manner that does jeopardize the tax-free quality of the reorganization.

A. Straight Merger

A straight merger is simply a merger of one corporation into another corporation pursuant to applicable state law. This is a relatively flexible form of reorganization because (i) shareholders of the entity being acquired may receive all stock or a combination of stock and other consideration (such as cash), (ii) shareholders receiving both stock and non-stock consideration are not taxable on the stock consideration provided the non-stock consideration is less than 60% of the total consideration, (iii) shareholders do not have to be treated equally (meaning some shareholders may receive cash, some all stock, others a combination of cash and stock), and (iv) certain restrictive provisions applicable to the other forms of reorganizations do not apply to straight mergers.

As a general rule, in a straight merger, some or all of the shareholders of the corporation being acquired may receive as much as approximately 60 percent of the sales price in cash or other non-stock consideration without being taxed on the stock portion of the consideration.

A potential non-tax problem with this form of reorganization is that the acquirer directly assumes the liabilities of the acquired corporation in the merger, which can pose a risk to the acquirer's other existing businesses and assets. This can be solved, however, by simply merging the corporation to be acquired into a wholly owned limited liability company subsidiary of the acquiring corporation (which is still treated as a straight merger for income tax purposes).

In any event, a straight merger will result in sales, use and perhaps other transfer taxes, which could be avoided using certain other reorganization formats (discussed below).

B. Stock for Stock

A stock-for-stock reorganization involves the acquisition of at least 80 percent of the stock of the corporation to be acquired *solely* in exchange for voting stock of the acquiring corporation. The acquiring corporation cannot pay a single cent of non-stock consideration. Though less flexible than the straight merger, in this type of reorganization, sale, use and transfer taxes are generally avoided and the acquirer also avoids the problem of directly assuming the liabilities of the acquired corporation. This is so because those liabilities remain, encapsulated in the acquired corporation (which becomes a subsidiary of the acquired

corporation). This same result may also be accomplished through use of a subsidiary merger format (discussed below), which is generally more flexible and therefore preferred to stock-for-stock reorganizations.

C. Stock for Assets

A stock-for-assets reorganization involves the acquisition of "*substantially all*" of the assets of the selling corporation solely in exchange for voting stock of the acquiring corporation. As is the case with the stock-for-stock reorganization, this format requires that solely voting stock of the acquirer be used; however, there is a special rule that permits non-stock consideration to be used so long as the total non-stock consideration given by the acquiring corporation (including assumption of the liabilities of the acquired corporation) does not exceed 20 percent of the total consideration given (including the liabilities assumed).

The stock-for-assets format offers the acquirer the benefit of not having to assume the unknown or contingent liabilities of the acquired corporation (either directly or via taking the acquired assets subject to such liabilities, as in a merger and a stock-for-stock reorganization). But, like the stock-for-stock format, it is only feasible when all or virtually all of deal consideration will be stock of the acquirer. Also, it leaves the shareholders of the selling corporation with the task of cleaning up and liquidating the selling corporation. Finally, in contrast to the stock-for-stock format, this type of reorganization will result in sales, use and other transfer taxes.

D. The Favored Formats -- Subsidiary Mergers

Subsidiary mergers are accomplished when the acquiring corporation forms a subsidiary corporation and either merges the corporation to be acquired into the subsidiary (known as a "*forward subsidiary merger*") or merges the subsidiary into the corporation to be acquired (known as a "*reverse subsidiary merger*"). Although the merger is between a subsidiary and the corporation to be acquired, stock of the corporation that owns the subsidiary (its "*parent*") is given as consideration to the shareholders of the corporation to be acquired.

The reverse subsidiary merger is the usual form of reorganization chosen, because (i) it protects the acquirer from the liabilities of the acquired corporation by keeping those liabilities separately encapsulated in the acquired corporation (which becomes a subsidiary of the acquirer), (ii) unlike all of the other reorganization formats except the stock-for-stock format, it avoids having to transfer legal title to assets (which, as a result, avoids sales, use and other transfer taxes), (iii) it often avoids anti-assignability provisions in the contracts of the corporation to be acquired, (iv) it permits up to 20 percent of the transaction consideration (without taking into account liabilities of the corporation to be acquired) to be paid in non-stock consideration, which is considerably more generous than available in the stock-for-stock and stock-for-assets formats.

The one drawback to the reverse subsidiary merger, compared to the straight merger and the forward subsidiary merger, is that the latter two permit as much as about 60 percent of the transaction consideration (without regard to the liabilities of the corporation to be acquired) to be paid in non-stock consideration. This advantage is often of limited benefit when the acquirer is a public company, since, subject to applicable securities laws and any contractual transfer restrictions that may be imposed by the acquiring corporation's investment bankers, a shareholder of a corporation acquired by a public company may usually dispose of all or a portion of its public company shares received in the reorganization in open-market transactions at any time.

Where the consideration in the deal will include at least 40% stock consideration but greater than 20% non-stock consideration (so the reverse subsidiary format would be taxable), the forward merger would be the preferred subsidiary merger format. However, if any requirement of a forward subsidiary merger is not met, the potential tax downside is quite serious. Specifically, the transaction would be treated as a taxable asset sale by the target corporation and then a taxable liquidating distribution from the target to the selling shareholders (giving rise to the double-tax problem). Where there is concern about whether a requirement of a forward subsidiary merger may be met, there are two possible ways to avoid the serious potential downside.

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The transaction could be structured as a straight merger using a wholly owned limited liability company subsidiary of the acquiring corporation to acquire the assets of the target (discussed above) or it could be structured as a so-called "*two-step merger*." In the two step merger, the target is first acquired via reverse subsidiary merger and, shortly thereafter, the target is either merged into another subsidiary of its new parent.

Pursuant to IRS rulings, if it turns out that any requirement of a forward subsidiary merger is not met, the transaction will be treated as a sale of stock by the target shareholders (giving rise to only one level of tax). If there is any question about whether all of the requirements of a forward subsidiary merger can be met, or if the seller will not be performing sufficient diligence to determine whether every such requirement can be met, use of the two-step merger format is strongly recommended.

"Blown" Corporate Reorganizations

Any transaction that meets the requirements of any of the reorganization formats is non-taxable for income tax purposes, which is usually the desired result. However, 'there the sellers would have a deductible tax loss if the transaction were not characterized as a "reorganization," planning should be considered to intentionally fail to meet one or more requirements of each possible reorganization format.

Conclusion

The involvement of qualified counsel throughout the process is imperative in minimizing the tax liability that can result and in meeting both the buyer's and the seller's respective tax and non-tax goals for the transaction and going forward.

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