

**SELLING THE BUSINESS:
PRACTICAL, TAX AND LEGAL ISSUES**

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1. Taxable vs. Tax-Free Deal

- Is seller comfortable moving from a highly concentrated position in target stock to a highly concentrated position in buyer stock? What if buyer stock is publicly traded? What if buyer expects to go public soon? What if buyer is rolling up several companies to achieve a critical mass and a high multiple of earnings?
- If seller has a short life expectancy, a tax-free, carryover basis deal might best position seller's heirs for a basis step-up in stock transferred after seller's death. Step-up applies at death of first spouse if the stock is held as community property.
- The focus of this outline is primarily on taxable sales of businesses.

2. The Total Purchase Price for Income Tax Purposes

- Cash down payment *plus* promissory note *plus* balance sheet liabilities assumed
 - ⇒ For this purposes, liabilities do not include periodic payments like rent

¹ *This outline is a very brief review of a complex subject. It should be viewed only as an abbreviated summary of the law and not as a substitute for tax or legal consultation in a particular case. Your comments and questions are always welcome.*

This outline was prepared on January 28, 2011 and does not reflect changes in the law after that date

3. **Allocate Seller's Gain Among the Assets Sold**

- Move down the balance sheet – Accounts receivable, inventory, furniture, fixtures and equipment, intangibles, goodwill. These are grouped in “Classes” of assets for allocation purposes.
- File Form 8594, Asset Acquisition Statement. The instructions explain the “Class” concept.

4. **Estimate the Seller's Tax**

- For a cash method seller, the sale of **accounts receivable** will generate ordinary income.
- **Inventory:**
 - ⇒ For a distributor, there is not likely to be any gain if the investment is sold at book value
 - ⇒ For a manufacturer, there will be gain in the finished goods and work in process, but probably no gain in the raw materials.
 - ⇒ Gain in inventory is taxed at ordinary income rates, even when sold in bulk.
 - ⇒ The seller will need to see the buyer's resale certificate to prove that sales tax should not apply to the sale of the inventory – because it will be held by the buyer for resale.
- **Furniture, fixtures, equipment and vehicles** will be subject to depreciation recapture – at ordinary income rates. Gain on amounts allocated to these assets in excess of the seller's purchase price is capital gain.²

² If the seller is a C corporation, all income and gain is taxed as ordinary income. There is no preferential long term capital gain tax rate for a C corporation.

- ⇒ FFE and vehicles will also be subject to sales tax if the seller has a sales tax permit.
 - ❖ It is the seller's duty to pay the sales tax.
 - ❖ But sellers often ask buyers to absorb the sales tax.
 - ❖ The buyer is secondarily liable for the sale tax. So the buyer needs a sales tax certificate by which the State Board of Equalization certifies that all of the sales tax has been paid, which addresses the buyer's concern.³
 - ❖ Consider pre-sale planning for sales tax.
- **Intangibles** include customer lists, the phone number, website and domain name, as well as patents, copyrights, know-how and trade secrets. Generally, gain on the sale of intangibles is capital gain, unless the seller keeps too many "strings attached."
 - ⇒ Intangibles are *not* subject to sales tax.
 - ⇒ Special filings or agreements might be needed to transfer some types of intangibles.
 - ⇒ **Stock, partnership and LLC interests** are treated as intangibles. However, sale of the interest in a disregarded **single-member LLC** (or the stock of a **Qsub**) is treated for income tax purposes as a sale of its assets and for sales and property tax purposes as a sale of the interest (or stock).
- The residual amount is **goodwill**. Goodwill is treated as capital gain.

³ The buyer can and should get a similar certificate from the EDD.

- Under the current tax laws:
 - ⇒ I would use 40% as the estimated effective federal and California tax rate for sales by a C corporation (41% for federal taxable income over \$10M) and 42% for ordinary income of an individual (43% if it flows through an S corporation subject to the California S corp tax).
 - ⇒ I would use 22% as the estimated effective tax rate on long-term capital gain of an individual (23% for a sale through an S corp).⁴
 - ❖ Capital gain tax on a sale often can be deferred until the year in which the seller received the sale proceeds. (This is the “**installment method**” of recognizing gain. It is possible to elect out of this method.)
 - ❖ The “**open transaction method**” – applying all basis to the first payments – can be used when there is sufficient uncertainty about the total price.
 - ❖ Consider how scheduled **increases in capital gain rates** (from 15% to 18% or 20%) affect the tax on deferred gain. **Collapsible corporation** issues are scheduled to resurface after 2012.
 - ❖ Generally, the installment method will apply to **purchase price adjustments in favor of the seller**. So they will be taxed to the seller when they are received.
 - ❖ The tax on the ordinary income portion must all be paid for the year of the sale.

⁴ This assumes that the seller has sufficient ordinary income to absorb all of the deduction for state taxes on the sale.

- When a C corporation sells assets, the corporation pays tax at an effective 40% tax rate. Then the shareholders receive the after-tax sale proceeds. The shareholders pay tax at a 25% rate on the amounts that they receive. The effective tax rate on this “**double tax**” is 53% ($40\% + (22\% \times (1-40\%))$).
 - ⇒ The double tax is reduced or eliminated if (1) the seller C corporation has operating losses to carry forward to absorb the corporate-level tax, or (2) the shareholders have losses that can shelter their gain on the receipt of the after-tax sales proceeds from the C corporation.

- If the seller **sells stock**, not assets, all of the gain is long-term capital gain (assuming that the seller held the stock for at least 12 months). **Sellers like to sell stock** for this reason and to avoid the hassle of dissolving the corporation. A stock sale requires less documentation and can require less negotiation with third parties, reducing transaction costs.
 - ⇒ A seller can sell some stock back to the corporation and the rest to others, and still have capital gain treatment. This is a “**Zenz**” **transaction**.
 - ⇒ A **sale of stock to an ESOP** might give the seller the best tax results – rollover of gain by using the sale proceeds to buy stocks or bonds of U.S. companies, seller liquidity from margin loans, and “deductible principal payments” for the company (as the indirect buyer).

- If the **seller is a “pass-through entity”** (that is, an S corporation, a partnership or an LLC taxed as a partnership), the entity’s gain will be taxed to the shareholders. The preferential tax rates on long-term capital gain can apply if the shareholders (of the S corporation) or the partner/members are not C corporations.
 - ⇒ An S corporation is also subject to a California tax of 1.5% of its taxable income.

- ⇒ If some of an S corporation's assets are subject the “**built-in gain**” tax, a nasty double tax can apply to the gain on the sale (or deemed sale) of those assets. The federal “recognition period” is five years for sales in 2011, then back to ten years. The California period is always ten years.
- ⇒ For a C corporation with a business that is appreciating in value, the S corporation election should be considered at every year-end.
 - ❖ When values are low, the built-in gain problem can be minimized. *So hard times are great times for S corporation elections.*

- **Interest income** received by the seller is ordinary income.

⇒ If the stated **interest rate** is well below the market rate, additional interest can be imputed for tax purposes. This creates a confusing mess.

- **Salary, consulting fees** or payments for a **covenant not to compete** are ordinary income to the seller. But they are usually paid directly to the individual shareholders and not to the selling corporation, so they are *not subject to the double tax*.
- **Purchase price adjustments in favor of the buyer** paid as refunds of purchase price or as indemnity claims generally are *not deductible* by the seller but are *long-term capital loss*. This can be carried forward *but not back*. This can be *very bad tax news* for the seller.
- **After 2012** the federal tax rates for non-corporate taxpayers are scheduled to increase, reducing after-tax sale proceeds to the sellers.

5. The Buyer's Tax Consequences

- The buyer will have full basis in the purchased **accounts receivable**. When the accounts are collected, there should not be any gain recognized unless the buyer collects more than the value assigned to the AR.

- The buyer will have ordinary income from the gross profit on the sale of the **inventory**.
- The buyer can deduct as **depreciation** over a short period of time the amount assigned to furniture, fixtures, equipment and vehicles. The buyer can amortize **leasehold expenses** over a somewhat longer period of time.
 - ⇒ *100% bonus depreciation* is available for purchases in 2011, and *50% bonus depreciation* in 2012. Favorable *Section 179 rules* also apply for purchases of depreciable assets before 2013.
 - ⇒ Note the tension between the buyer's wish to depreciate assets quickly and the *sale tax* on tangible personal property not held for resale.
- The buyer amortizes and deducts over 15 years the purchase price allocated to **intangibles** and **goodwill** and to payments for the seller's **promise not to compete**.
- If the buyers buys **stock**, the buyer gets no tax benefit from the purchase price until the stock is sold or the target corporation liquidates.⁵
 - ⇒ If a corporate buyer buys target stock and later **liquidates the target into the buyer/parent**, the buyer's basis in the target stock can *disappear*, with a carryover basis in its assets. This can also happen if the buyer/parent is an S corporation and makes a **QSub election** for the target.

⁵ It is possible for the buyer to get a tax benefit sooner if the selling shareholders make a "**Section 338(h)(10) election**" or the buyer corporation makes a "**Section 338(g) election**" (sometimes just called a "Section 338 election"). The (h)(10) election is common when the target is an S corporation. The Section 338(g) election is generally used only when the buyer corporation has operating losses to shelter the gain that results from the election.

- ⇒ Even if the buyer buys stock, it's ability to use the target's operating **loss carryforwards** and **credit carryforwards** will be severely limited.
- ⇒ For these reasons, **buyers generally prefer to buy assets**. This also allows the buyer:
 - ❖ To choose the **type of entity** and **tax elections**.
 - ❖ To minimize the risk of buyer paying **seller's liabilities**.
- If the buyer is a C corporation or a pass-through entity in which the shareholder/member of the buyer entity is active, then the **interest expense** will be deductible by the buyer as "trade or business" interest.⁶
- **After 2012** the tax rates for non-corporate taxpayers are scheduled to increase. That will *reduce* the after-tax return of buyers who hold the business in a pass-through entity. Conversely, it will also make the deductions *more valuable*.
- If there is **corporate tax reform** with lower C corp tax rates and fewer or limited deductions, some of the buyer's anticipated tax benefits of the purchase could change.

6. The Buyer Entity

- Generally, if the business will be enhanced and **re-sold** in a few years, the buyer entity should be an LLC or, second best, an S corporation.
 - ⇒ The buyer should be aware of the **anti-churning** rules for intangibles when the buyer becomes the seller.

⁶ There can be circumstances in which the interest paid is not deductible in the year in which it is paid.

- If the exit strategy for the buyer’s investors is an **IPO**, then an S corporation would be best, if the shareholders are eligible. A C corporation would be second best. (LLCs just don’t go public.)
- If a likely strategy is a **tax-free stock swap**, it can be accomplished directly if the buyer entity is a corporation, whether S or C. However, an LLC can often accomplish the same thing by creating a new entity and using Section 351.
- If the buyer is **not eligible to hold S corp shares**, an LLC might be best. However, if the buyer has **foreign investors** or **tax-exempt investors**, a C corp (perhaps a “blocker corp”) might be the best choice.
- If issuing **stock options** to management is important to the buyer, and the managers are not already partners for tax purposes, a corporation might be preferable to an LLC, in which the tax consequences of compensatory options are less familiar.

7. **Is an Asset Sale Practical?**

- **Contracts** of target (supplier contracts, customer contracts, distribution contracts, leases, lines of credit, etc.) – can they be assigned to the buyer entity?
- **Licenses, government/vendor authorizations** and **billing codes** of target – can they be assigned or acquired by the buyer entity?
- The buyer entity can generally use the **name** of the seller, but the seller entity might have to change its name to permit the buyer to use that name.

⇒ **Trademarks** and **trade names** can be assigned.

8. **Protecting the Buyer from the Seller’s Liabilities**

- The buyer in an asset deal should make a **bulk sale filing** to cut off the buyer’s liability for claims against the seller.

- ⇒ The claims are not limited to those on the seller's balance sheet.
- ⇒ One of those claims is the seller's income tax arising from the sale.
- The buyer could also arrange a **hold back or escrow** until the SBE and EDD provide certificates of release.

9. The Sale Process

- Hire an **investment banker** or **business broker**, depending on the value of the business.
- Seller gets a **valuation** of the target business. Identifies what can be done short-term and long-term to "**groom**" the business to increase the value.
 - ⇒ Upgrading the **financial statements** from compiled to reviewed or audited might boost the value and make the business interesting to more prospective buyers.
 - ⇒ Clean up the **accounting records** and **stock ownership records**, so there are no bad surprises in a buyer's due diligence process.
 - ⇒ Review all **S corporation and related elections** to be sure they have been properly made.
 - ⇒ Prepare seriously for the **due diligence** process.
 - ⇒ Consider **pre-sale combinations** to achieve a higher multiple of EBITDA.
- Consider **estate planning** and **charitable contributions** that might interest the seller after the sale. There might be great strategies (for example, gifts of stock to the next generations,

short-term GRATs, sales to grantor trust or charitable remainder trusts) that can best be implemented *before* a possible sale.

- Investment banker/business broker seeks interested buyers and, with the seller, **identifies the best prospect**.
- Seller and prospective buyer sign **Nondisclosure Agreement**.
- Each party obtains **tax and legal advice** about the structure of the proposed transaction. A party who skips this step is probably at a *severe disadvantage* in terms of both tax benefits and transaction costs.
- Prospective buyer delivers **letter of intent** or **term sheet** to seller.
 - ⇒ Anticipating **negotiation issues** at this point can save hours negotiating and revising the purchase agreement.
 - ⇒ Both sides want to close the deal on these terms unless something major comes up in the due diligence process, while negotiating the purchase documents, or while working to satisfy the closing conditions.
 - ⇒ Using **experienced advisors** can minimize the risk of bad, expensive surprises after the letter of intent.
- Buyer does “**due diligence**” investigation of target business.
 - ⇒ Seller must be ready and anticipate buyer’s reasonable requests.
 - ⇒ A physical or virtual **data room** is sometimes used to make data available to buyer and to speed the process of preparing representations in the purchase agreement.
 - ⇒ The seller might need to hire **temporary high-level administrative assistance** to handle routine staff functions

to free a key person or team to facilitate the due diligence process.

- Buyer prepares **purchase agreement**.
 - ⇒ Articulates deal structure, pricing, payment, and conditions to closing.
 - ⇒ Seller makes detailed representations, *even though buyer has done due diligence*.
 - ⇒ Seller promises to indemnify buyer for breach of reps, subject to limitations
 - ⇒ Possible holdback of purchase price or escrow to provide funds to satisfy sellers duty to indemnify
- Seller prepares **promissory note** (if needed) and documents to **secure** the note.
- The seller's management team should **defer vacations** and **minimize out-of-town trips** during this period. Don't schedule anything until after the final closing, and don't try to anticipate the closing date and thus become desperate to close.
- The buyer and seller **sign the sale documents**. The transaction might close on this day.
- Otherwise, the buyer and/or seller complete the **conditions to the sale** (getting financing or government approvals, transferring licenses, releasing guarantees by target principals, etc.).
- When the closing conditions are satisfied, the sale closes, **payment** is made and **the business changes hands**. If there is a hold-back of part of the price in an escrow, the **escrow is funded** by the buyer.

- The buyer makes the **filings** necessary to reflect the change of ownership.
- There may be **price adjustment** after the closing for the working capital in the target at the closing.
- Eventually, the **indemnification period** ends. If an escrow was used, the funds left in the escrow are disbursed to the seller.
- If the seller entity (in an asset sale) did not dissolve after the closing, the **entity dissolves** at the end of the indemnification period or when the buyer's promissory note is paid in full.

10. **What to do with the Seller Entity After an Asset Sale Closes**

- The seller corporation or LLC remains liable for claims against it, even though it sold its only business.
 - The shareholders or members are liable up to the amount of the **liquidating distributions** that they received from the entity.
 - If the entity dissolves, claims can be brought for **four years** after the dissolution (for California corporations and LLCs).
 - So, the sooner the entity is dissolved, the sooner claims will be barred by the four-year rule.
 - Before making the final liquidating distribution to the shareholders/members, the seller entity should obtain "**tail**" **liability insurance** that will remain in effect for a specific period of time (often the remainder of the four-year period) even though no further premiums are paid.
- ⇒ But recall that payments to the buyer from the seller after the closing will be **capital loss** to the seller and not very useful, tax-wise. So there is a tension between *dissolving soon* to limit liability or *waiting to dissolve* so that the entity can retain funds to pay its own claims.

- For a C corporation (but not for an S corporation with no built-in gain issue), **distributing the promissory note** – or electing S corporation status – will accelerate the deferred gain on the note.

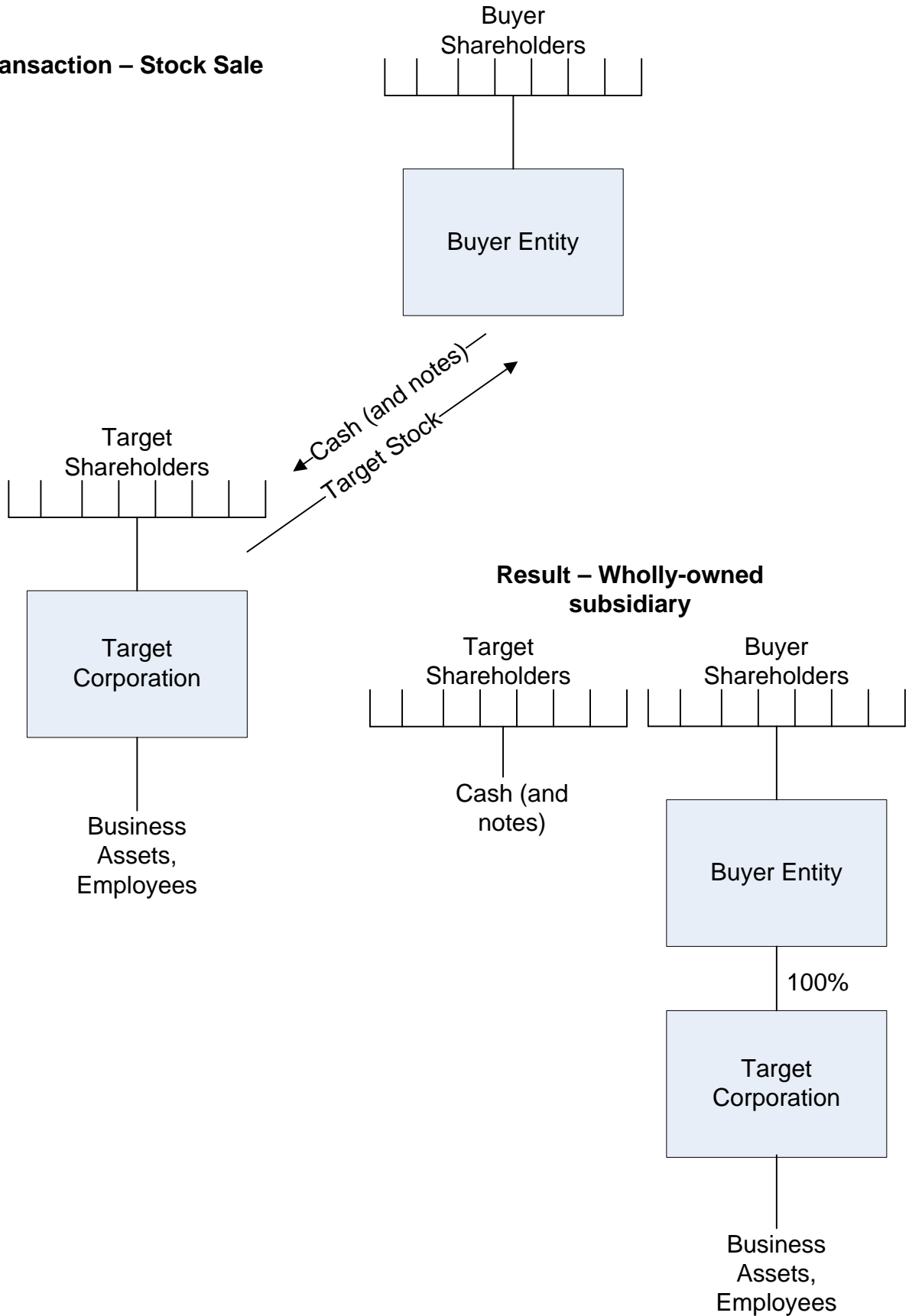
- If the seller collects interest and/or rent after the sale ...
 - ⇒ ... and the seller is an S corp with C corp earnings and profits and, it will need to manage its **excess passive receipts** to avoid penalty taxes and loss of S corp status; or

 - ⇒ if the seller is a C corp, it will need to manage its **personal holding company** issues to avoid a double tax.

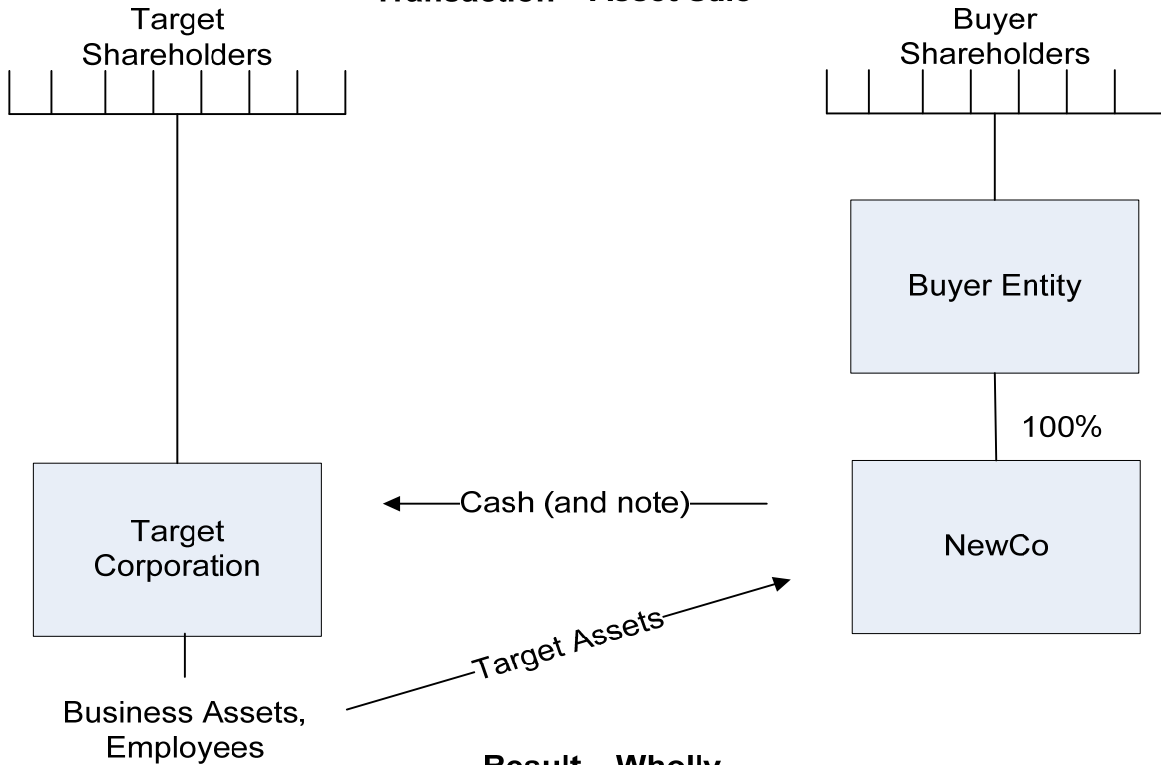
 - ⇒ These are not concerns for sellers that are LLCs or are S corps with no C corp e&p.

[End of outline.]

Transaction – Stock Sale



Transaction – Asset Sale



Result – Wholly-owned subsidiary

