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TAX STRATEGIES FOR BUYING AND SELLING BUSINESSES

by

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1. INTRODUCTION

The 2006 Tax Act extended the 15 percent federal capital gains and dividend rate until December 31, 2010.[1] These lower tax rates reduced the Federal tax cost of selling a business. However, California has an additional one percent tax on adjusted gross income over $1,000,000,[2] which is in addition to the regular California maximum individual tax rate of 9.3 percent.

[1] The bill is known as the Tax Increase Prevention and Reconciliation Act of 2005 ("2006 Tax Act"). This tax bill was introduced into Congress in 2005, so its name carries a "2005" designation, rather than 2006.

[2] Proposition 63 passed by California voters in 2004 amended the California Constitution and enacted the "Mental Health Services Act" which imposed this additional 1% tax.

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Because of the potential double level of income taxation on the asset sale of a business (first at the C corporate level and then at the individual level), the tax consequences of a business's sale will be governed by what type of legal entity owns that business -- partnership, limited liability company, S corporation or C corporation.

Careful tax structuring of the selling entity, spinning off the selling entity's assets and properly allocating the purchase price among sold assets, intangibles and employment agreements will maximize the tax benefits to clients who sell or purchase a business.

1.1 ***Double Level of Taxation on the Sale of Assets of a C Corporation***. Many businesses being sold are owned by C corporations, which produces two levels of taxation in an asset sale – first at the corporate level on the assets' sale, and second at the shareholder level when the assets' net sales proceeds are distributed to the shareholders in a corporate liquidation.[3]

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[3] This double level of taxation became an issue after the Tax Reform Act of 1986 and the repeal of the ***General Utilities*** doctrine. The repeal of the ***General Utilities*** doctrine results in a C corporation paying a corporate level tax on its income, and the shareholders paying shareholder level tax on corporate distributions made to the shareholders out of the corporation's earnings and profits, resulting in a double level of taxation on the same income.

Prior to 1986 when assets of a C corporation were sold, there was only one level of taxation and this had been the law for the immediately prior 50 years. This pre-1986 tax rule was memorialized (continued...)

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(a) **<u>Combined Federal and California Tax Rate on C Corporations</u>**. Even with the low 15 percent maximum federal capital gain rates, this <u>double level</u> of taxation of the purchase price paid in an asset sale by a C corporation produces a 53.25 percent tax rate after taking into account the effect of California tax.[4]

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[3](...continued)
in former §337 under the so-called "12-month liquidation" which stated that as long as the sale of the assets and the liquidation of the assets sale's proceeds occurred within a 12-month period, there would be no gain taxed at the corporate level.

[4] For federal purposes, there is a maximum corporate tax rate of 35% on the monies paid to the C corporation, and an additional individual tax on the distribution to the shareholder of 15% maximum capital gain rate, leaving a combined corporate individual capital gain rate of 44.75 percent. Applying the California corporate tax of 8.84% and the California individual maximum tax rate of 9.3% produces a combined federal and California tax rate of 53.25%.

This combined 53.25% rate is reduced to 52.5% (because of the lower 34% maximum corporate federal rate) for corporations that have income that does not exceed $10,000,000. Additionally, under §11(b), there are lower corporate income tax brackets commencing at 15% and going as high as 25% for taxable income up to $75,000.

The rate advantages of the lower 34% federal corporate tax rate and other lower federal brackets are phased out. As a result of these phase outs, the effective <u>federal corporate income tax rates are as follows</u>:

Taxable Income	Rate
Up to $50,000	15%
Over $50,000 but not over $75,000	25%
Over $75,000 but not over $100,000	34%
Over $100,000 but not over $335,000	39%
Over $335,000 but not over $10,000,000	34%
Over $10,000,000 but not over $15,000,000	35%
Over $15,000,000 but not over $18,333,333	38%
Over $18,333,333	35%

See Bitker and Eustice, ***Federal Income Taxation of Corporations and Shareholders***, 7th Ed.,
(continued...)

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In addition to this 53.25 percent combined California and federal corporate and individual tax rate, California has an additional one percent tax on individual taxable income over $1,000,000.

California currently has the highest individual state income tax rate in the United States for those persons in the top tax brackets (because of the gain generated in a taxable business sale those persons selling their businesses are likely to be in this highest tax bracket).[5]

The current combined 53.25 percent maximum tax rate on an asset's sale gain should be contrasted with the sale of the business by a corporate stock sale which produces only one level of tax on the gain for a low combined 21.04 percent maximum federal and California capital gain rate.[6]

There has been no special lower federal corporate capital gain rates since 1987. There is no lower California capital gain rate for corporations or for individuals. California treats capital

[4](...continued)
at ¶5.01.

[5] See the website of Federation of Tax Administrators at **www.taxadmin.org/fta/rate**.

[6] This 21.04% combined tax rate is based upon the maximum 15% federal capital gain rate and the maximum 9.3% California individual tax rate, taking into account the state income tax deduction for federal taxes. In addition, to this combined 21.04 %, there is the 1% California tax on adjusted gross income in excess of $1,000,000.

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gains as ordinary income, and thus the amount of California capital gain tax is not dependent on the holding period of the capital asset.

> **<u>PLANNING IDEA</u>: Selling shareholders can <u>change their residency</u>** to <u>outside of California</u> prior to <u>selling the stock</u> of their business in order to avoid the California individual income tax on the stocks' sale's gain.[7] A California resident who moves to Nevada, Florida or other "no-tax" state (and becomes a non-California resident) only pays a 15 percent federal capital gains tax (rather than the 21.04% blended California and Federal tax plus the 1% individual California surtax). However, the C corporation with a California situs will itself still be subject to California corporate franchise taxes.

(b) **<u>Potential Increase in Tax Rates</u>**. The following tax reductions and phase-out eliminations will sunset in 2011, and thus there will be an increase in tax rates:

(i) Ordinary income rates will increase from 35% to 39.6%;

(ii) Long-term capital gain rates will increase from 15% to 20%; and

---

[7] Income from intangible property of nonresidents which has acquired a California business situs is allocated to California, including gains from the sale of such property. Cal. Reg. 18 §17952(c); Rev. & Tax. Code §17952. However, stock owned by a <u>non-resident</u> of California is not subject to California tax on its sale.

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(iii) Qualified dividend tax rates will be increased from 15% to ordinary income rates of 39.6%.

(c) **Effect of the Alternative Minimum Tax On the Sale of a Business**. These tax rates assume that there is no federal individual alternative minimum tax ("AMT") at the shareholder level which is at a maximum 28 percent federal AMT rate. State income taxes which are deductible for regular tax purposes on Schedule A of Form 1040 are not deductible in computing the AMT. Therefore, because of California's high income tax rates, many clients will be subject to the Federal AMT where the clients have a large amount of taxable gain (and resulting California personal income taxes) from the sale of their business. California has a modified AMT for individuals and corporations.

A federal corporate AMT is imposed under §55. For a description of the corporate AMT see Bitker & Eustice, ***Federal Income Taxation of Corporations and Shareholders***, 7th Ed., at ¶5.08.

(d) **Corporations Will Be Able to Reduce Their Taxes By the Production Activities Income Tax Deduction**. The American Jobs Creation Act of 2004 created a new deduction for qualified production activities income which effectively reduces the tax rate for C corporations, partnership, LLCs, and even proprietorships.

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This new phased-in production activities "percentage" deduction equals <u>three percent</u> for 2005 and 2006 tax years; <u>six percent</u> for 2007 through 2009 tax years; and <u>nine percent</u> for 2010 and thereafter. This deduction equals the applicable percentage multiplied times the <u>lesser</u> of: (i) the taxpayer's "qualified production activities income" which is its U.S. manufacturing production income; or (ii) the taxpayer's taxable income. [See new §199.] However, this new production deduction may not exceed 50 percent of the W-2 wages paid by the taxpayer for the tax year which are deducted for qualified production activities income. The result of Code §199 is that the effective tax rate for C corporations is reduced.

1.2 ***<u>Buyer's Tax Issues in Purchasing a Business</u>***. The buyer's cost to purchase a business will be reduced to the extent of the buyer's tax benefits received from the acquisition of the business. For example, if the buyer's purchase price on the sale is allocated to immediately deductible items or the purchased assets can be amortized over short time periods, the buyer benefits by these increased tax deductions. On the other hand, the seller's goal is to reduce or avoid any immediate tax liability on the business's sale. The tax result to the buyer and seller of a business will depend on how the business's purchase and sale is structured (e.g. stock sale or asset sale), how the allocation of the purchase price is made (e.g. how much of the price is allocated to quickly tax

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depreciable assets), and whether the transaction is structured as a taxable sale or as a tax-free reorganization.

1.3 ***General Tax Themes of Buying and Selling a Business***. Although every business's acquisition has its own unique issues, some general tax themes are:

- The selling shareholders will prefer a stock sale (and not to sell the assets of a C corporation) in order to produce only one level of taxation (taxed at lower capital gain tax rates at only the shareholder level).

- In the absence of non-tax reasons for selling shares (such as the inability to transfer a license or franchise), the business's buyer generally prefers an asset acquisition in order to obtain a stepped-up tax bases in the acquired business's assets and to reduce the buyer's exposure to pre-closing liabilities.

- An asset sale generally results in the selling C corporation and its shareholders paying a much higher effective tax rate (both a C corporate level tax and a shareholder level tax). Therefore, in a C corporation asset sale the selling shareholders will have to demand a higher purchase price to realize the same after-tax proceeds as if there were a stock sale.

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PLANNING IDEA: If the Selling C Corporation Has Operating Losses, Then the Selling Corporation Can Use These Tax Losses to Avoid Gain on an Assets' Sale. If the selling/target C corporation has operating losses (or loss carry forwards), then the corporation may be able to use these losses to shelter the gain on an asset sale, while still giving the assets' buyer a stepped-up asset tax basis. However, the Acquiring Corporation's operating losses cannot be used to offset the Target's gain.

2. SALE OF THE SELLING CORPORATION'S SHARES

This is the simplest technique by which a seller (e.g. the shareholders of the "Target" C corporation) can avoid the "double level" of taxation on the sale of the business. The selling shareholders assign all of their shares to the buyer in exchange for cash or a note. The selling shareholders receive sale or exchange treatment on the sale of their stock, and realize taxable gain equal to the difference between what they receive and their shares' tax basis. The sold stock's gain is taxed to the selling shareholders at capital gain rates which will be a 15 percent maximum federal capital gain rate for individuals in the highest tax bracket plus the California state income tax. [See paragraph 1.1(a) above for tax rates.]

2.1 ***Tax Basis of the Sold Shares***. Commonly the tax basis of closely held corporation stock is low. In community property

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states such as California, shareholders receive a §1014 fair market value basis for their entire share ownership (which is community property) upon the death of the first spouse.[8] Such a stepped-up basis could result in no gain to the selling shareholder.

If the selling corporation owes debt to a shareholder, upon the sale of the business this debt can be contributed to the corporation to increase the stock's tax basis. Alternatively, the debt can be paid back tax-free to the shareholder, or the corporation could redeem the shares immediately prior to the stock's sale in exchange for the debt.

2.2 ***How to Distribute Non-Sold Assets In a Stock Sale, Such as Cash, Accounts Receivable and Automobiles***. Many times when a corporate business is sold the selling shareholders desire to retain certain assets such as cash, real estate, accounts receivable, computers, furniture and art, or shareholder automobiles. In a stock sale, one technique to accomplish this goal is to have a partial stock redemption in exchange for these "special" assets immediately prior to the sale. However, if there is inherent gain in these special assets (such as cash basis accounts receivable, depreciated automobiles or appreciated real estate), there will be gain taxed to the selling "Target" C

[8] Under current federal tax laws this step up in tax basis will be repealed for one year in 2010 under the 2003 Tax Act. However, it is predicted that Congress will amend these tax rules.

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corporation equal to the difference between the fair market value of the redeemed "special" assets and their tax basis.

> **PLANNING IDEA**: Consider reducing such "special" assets' gain by not redeeming low basis assets or by valuing these "special" redeemed assets at a low fair market value.

2.3 ***Post-closing Adjustments***. Commonly in a business sale there are post-closing adjustments between the buyer and seller for accounts payable or collection of accounts receivable. Additionally, there may be contingent liabilities for which the seller is responsible which arise after the closing. If it is desired for post-closing adjustment payments to shareholders to be taxed at capital gain rates, then the stock purchase agreement should state that post-closing adjustments relate to the sale of the stock.

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PLANNING IDEA: **How can the selling/Target shareholders have the transaction structured as a stock sale?** If you represent the seller of a business who desires to have a stock sale, you should tell the buyer at the beginning of negotiations that you require a stock sale as a "deal point" rather than leaving this issue open until later.

Most buyers of shares will request that the stock sale documents include the selling stockholders' representations and warranties regarding liabilities and pre-closing debts, etc.

The buyer may offer to pay the seller a lower purchase price in a stock sale in order to take into account the fact that the buyer will have a lower cost basis in the purchased business's assets.

2.4 ***Tax Result to the Acquiring Corporation That Buys the Shares of the Target Corporation, Followed By That Acquiring Corporation Liquidating the Purchased Target Corporation Into the Acquiring Corporation***.

(a) **General Rule is There is No Gain to the Acquiring Corporation, and There is No Step-Up in the Selling Target's Assets' Basis.** The stock's buyer is a corporation ("Acquiring corporation"). The Acquiring corporation first purchases all of the Target corporation's shares, followed by that Acquiring corporation liquidating the selling/Target corporation. The tax treatment under §332 is that the Acquiring corporation recognizes no gain or loss on the liquidation of the new subsidiary/Target

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corporation. [§332(a).] The selling/Target corporation (which becomes a subsidiary of the Acquiring corporation) also does not recognize gain upon its liquidation into the Acquiring corporation. [§337(a).] The parent Acquiring corporation, however, acquires the Target corporation's assets at the Target's assets' then tax bases (and not a stepped-up tax bases). [§334(b)(1).]

The Acquiring corporation may not be satisfied with this lower tax bases in the Target's assets, since a low assets' tax bases results in the Acquiring corporation receiving less depreciation deductions and recognizing more future gain upon the sale of these assets (including future inventory sales), all of which results in higher future income taxes to the Acquiring corporation.

(b) **Make a Section 338 Election to Increase the Target's Assets' Tax Bases**. To increase the tax bases in the Target corporation's assets, the Acquiring corporation can make a §338 election.

When the Target corporation's stock is sold to an Acquiring corporation, the Target corporation becomes a subsidiary corporation of the Acquiring corporation. By making a §338 election, the Acquiring corporation can then elect to treat its new Target subsidiary: (i) as having sold all of its assets to the Acquiring corporation in a single transaction for the assets' fair

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market value, and (ii) as if the Acquiring corporation was a new corporation purchasing the Target corporation's assets on the day after the acquisition. The tax result of a §338 election is that: (i) the Target corporation, as a subsidiary of the Acquiring corporation, recognizes gain as if it liquidated, and (ii) the Target corporation's assets acquire a new tax bases equal to their fair market value, which should equal the purchase price of the Target corporation's stock. The Target corporation remains in existence and is the exact same legal entity under state law that it was on the day before the stock sale. However, for income tax purposes, the Target corporation now has a new tax basis in its assets, and no earnings and profits or other previous tax attributes.

The major disadvantage of a §338 election is that after the sale the Target corporation (whose income may then be reported by the Acquiring corporation's consolidated group) is required to recognize gain on this deemed §338 sale of its assets. Since gain will have to be recognized under a §338 election, this election is tax inefficient and most taxpayers will probably not make this §338 election. Making a regular §338 election will be advantageous, for example if the Target/selling corporation has net operating losses to offset the recognized gain (but the Acquiring corporation's losses cannot offset the Target's gain).

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(c) **Requirements to Make §338 Election**. To qualify for a §338 election, the buyer (Acquiring corporation) must: (i) be a corporation, (ii) purchase at least 80 percent of the selling/Target corporation's stock within a 12-month period [§338(d)(3)], and (iii) must make the §338 election by filing Form 8023 with the IRS.

(d) **Target's Corporate Existence Preserved**. If a §338 election is made, the buying corporation can still elect to keep the Target corporation in existence for state law purposes in order to preserve any of the Target's special franchises, licenses, leases or contracts.

(e) **Effect of §338 Election on the Selling Shareholders of the Target Corporation**. Normally a §338 election is made by the Acquiring corporation. As such, the election does not affect the Target corporation's shareholders. Sellers of the Target corporation's stock recognize capital gain equal to the difference between the sellers' stock's sales price and the stock's tax basis. The §338 gain is reported on the Acquiring corporation's consolidated tax return.

(f) **The Deemed §338 Tax Can Be Reported On the Target's Tax Return By Making a §338(h)(10) Election**. An alternative election available under §338 is the §338(h)(10) election. Under

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§338(h)(10) the <u>Target corporation recognizes gain</u> as if it sold its assets to the Acquiring corporation. The "(h)(10)" election is available if the Target corporation is a member of an affiliated group (regardless of whether consolidated returns are filed). [Reg. §1.338(h)(10)-1(e)(1).]

The result of an (h)(10) election is that the Target corporation can dispose of its assets to the buying corporation with only one tax at the Target corporation's level. <u>The Target corporation's affiliated group then bears the tax of the §338 deemed asset sale</u> (rather than the Acquiring corporation). <u>No gain or loss is recognized</u> when the Target selling corporate shareholders <u>sell their Target corporation's stock</u> to the Acquiring corporation. The Acquiring corporation thus acquires the Target corporation (by the purchase of the Target's stock) with a stepped-up tax bases in the Target corporation's assets.

> **<u>PLANNING IDEA</u>:** An "(h)(10)" election should be considered by a Target/selling consolidated group, when the selling Target corporation's assets have <u>less</u> inherent gain than the parent's inherent gain in the Target's stock, or when the selling Target consolidated group has current operating losses or NOL carryovers. An "(h)(10)" election causes a <u>tax on</u> the selling corporation's <u>assets</u>, while <u>no taxable gain</u> is recognized on the Target shareholders sale of their stock.

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(g) **Use of a §338(h)(10) Election By a Target S Corporation.** The (h)(10) election can be used by S corporation shareholders on the sale of their stock in order to cause only the Target S corporation's assets' gain to be taxed to the Target S corporation (and then this gain is passed through to the Target S corporation's shareholders). The Target S corporation shareholders recognize no gain on the shareholders' sale of their S stock to the Acquiring corporation.

The (h)(10) election, like the conventional §338 election, produces a stepped-up tax bases in the Target's assets. If an S corporation is the Target corporation and makes an (h)(10) election, then the assets' sale gain is reported on the final Target S corporation return.[9] The S corporation's gain then passes through to the Target S corporation shareholders and increases their stock basis. The S corporation shareholders are treated as receiving the assets' sale proceeds in a liquidation distribution, which could result in further gain or loss being recognized to the S corporation shareholders under §331; however, the asset sale gain passing through to the Target S corporation shareholders by the (h)(10) election causes a increase in the S corporation shareholders' stock basis which may shelter such deemed distribution of the assets' sale proceeds to these shareholders.

[9] S corporation tax can include a §1374 built-in gains tax, and the California 1-1/2% tax on S corporation earnings.

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S corporations that are targets of an acquisition and are considering using of an "(h)(10)" election must realize that having a deemed asset sale occurring (rather than a sale of stock) may result in some ordinary income being passed through to the shareholders on the deemed sale of certain S corporation assets (such as §1245 recapture on personal property assets), rather than having solely capital gain treatment if instead there was a sale of the S corporation stock.

The §338(h)(10) election can occur only with the consent of the Acquiring corporation and all of the selling/Target S shareholders (including any shareholders who do not sell their S corporation stock).

3. SALE OF THE TARGET CORPORATION'S ASSETS

Buyers of businesses generally prefer to have a taxable asset sale in order that the tax bases of the purchased assets are increased. Additionally, buyers generally want to allocate the purchase price to items that can be expensed or written off over short time periods. For example, allocations to furniture, equipment and machinery can be written off under MACRS on a double declining method over five to seven years. On the other hand, allocations of the purchase price to covenants not to compete,

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goodwill and certain intangible assets requires that the buyer amortize these assets over 15 years straight line under §197. Buyers may wish to avoid allocations to real estate, since the amortization for non-residential improvements is over 39 years under the straight-line method, and the land portion of the real estate cannot be depreciated.

An asset purchase reduces the buyer's exposure to unknown Target liabilities and gives the buyer a "clean start" with the acquired Target business.

For tax purposes, an asset sale is considered a sale of each individual asset, rather than the sale of a single business entity. Therefore, the purchase price must be allocated among the acquired assets in order to determine the gain to the Target/selling corporation. In an asset sale the Target/selling corporation recognizes gain or loss equal to the difference between the purchase price paid and the tax basis of the Target/selling corporation's assets.

3.1 ***What If the Target/Selling Entity is a Single Member LLC Owned By a Corporation?*** If the selling Target entity is a single member LLC owned by a parent corporation, then that parent corporation is treated for tax purposes as if that parent corporation owned directly all of the assets of the single member

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LLC. The result is that the parent/selling corporation (and <u>not</u> the single member Target LLC) is treated as directly selling all of the LLC's assets to the Acquiring/buying corporation.

3.2 ***<u>Required Allocation of Purchase Price Among the Sold Assets Under §1060</u>***. Because of the difficulty of establishing goodwill value and going concern value, and because of taxpayer abuse, Congress enacted §1060 under the Tax Reform Act of 1986. Section 1060 mandates the application of the "residual method" for allocating the total purchase price of an "applicable asset acquisition" among the various business assets. An "applicable asset acquisition" is defined in §1060 to mean any transfer of assets which are a trade or business where the transferee's basis is determined by reference to the consideration paid for such assets.

In an effort to promote uniformity between a §338 transaction and asset sales, Congress in enacting §1060, and the Treasury Department in promulgating regulations under §1060, attempted to mirror §338.

(a) **<u>Stock Sale and §1060</u>**. The §1060 information reporting requirements not only apply to asset acquisitions, but also apply where a <u>10 percent or more owner</u> of an entity transfers an interest in such entity (e.g. stock) and in connection with such

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transfer, such person or related person enters into an employment agreement, covenant not to compete, royalty or lease agreement or other agreement with the transferee. [§1060(e)(1).]

(b) **Sections 338(h)(10) and 1060**. In the case of an Acquiring corporation, where a §338(h)(10) election is made whereby a Target corporation sells its assets to an Acquiring corporation, the same principles of §1060 reporting must be followed. This requirement allows the Internal Revenue Service to monitor §338(h)(10) elections to ensure consistent reporting. In a regular §338 election, it is not possible to take an inconsistent position, since all returns are filed by one corporation.

3.3 ***Required Allocation of Consideration Under §1060***. Section 1060 (and the Regulations thereunder), under the "residual method" of allocation, classifies assets as Class I, II, III, IV, V, VI and VII assets. The purchase price is then allocated among the seven asset classes, as described below. Within each asset class, the purchase price is allocated among that class's assets in proportion to the fair market value, and may not, with respect to any asset, exceed the asset's fair market value on the purchase date.

The seven asset classes are as follows:

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Class I - Cash, demand deposits, bank and savings and loan accounts. The purchase price is allocated to the Class I assets to the amount of the Class I assets.

Class II - Readily marketable stocks and securities, foreign currency and other similar items.

Class III - Certain debt instruments.

Class IV - Inventory and stock in trade.

Class V - All assets not included in any other class, both tangible and intangible, such as furniture, fixtures, land, buildings, leases, contracts, equipment and accounts receivable.

Class VI - Class VI assets are all §197 intangible assets (such as a covenant not to compete), except for goodwill and going concern value.

Class VII - Section 197 assets in the nature of goodwill and going concern value. All remaining consideration, i.e., "residual" consideration, is allocated to Class VII assets.

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The first step in allocating the consideration (purchase price) among the purchased assets is to allocate the purchase price first to the Class I assets, with the remaining purchase price then allocated to the Class II, III, IV, V, VI and VII assets, respectively. The allocations of the purchase price among assets in each class is made in proportion to the fair market values of the assets within each such class on the purchase date.

3.4 ***If the Buyer and Seller Agree in Writing on the Allocation of Assets' Values, is That Allocation Agreement Binding On the IRS?*** Section 1060(a) specifies that a written agreement made by buyer and seller as to the allocation of assets' purchase price (within the above classes) shall be binding on buyer and seller, unless either: (i) the IRS determines that such allocation or value is not appropriate; or (ii) the parties are able to refute a mistake. [See §1060(a).] The buyer or seller can still challenge amounts allocated under a contract allocation based upon a claim of mistake, undue influence, fraud, duress, etc.[10]

3.5 ***Example***. Buying corporation acquires all of the assets of Target/selling corporation on September 1, 2004, paying $1,000,000 in cash and assuming $500,000 in Target's/seller's

[10] See Committee Reports to the Revenue Reconciliation Act of 1990, and Reg. §1.1060-(2)(c)(4).

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liabilities, for a total purchase price of $1,500,000. The purchase price is allocated under §1060 as follows:

Asset	FMV	Class
Savings accounts and cash	$ 300,000	I
IBM stock	$ 200,000	II
Furniture, equipment and tenant fixtures	$ 500,000	V
Leasehold interest in favorable real property lease	$ 100,000	V
Inventory	$ 100,000	IV
Customer lists	$ 100,000	VI
TOTAL	$1,300,000	

The $200,000 remaining balance is allocated to goodwill, as a Class VII asset.

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3.6 ***Post-closing Adjustments to Purchase Price***. In most business sales, there will be some post-closing adjustments. These adjustments may simply take the form of adjusting for accounts payable or accounts receivable determined after the closing date. Alternatively, the purchase price may be contingent upon the earnings performance of the sold business. Finally, a violation by the Target/seller of a representation and warranty (such as a lawsuit after the closing for events occurring before the closing date) may result in the Target/seller having to rebate a portion of the purchase price back to the buyer. The Regulations under §1060 specify that an increase in the purchase price back is allocated among all of the transferred assets.

3.7 ***Reporting Requirements of Asset Sales Under §1060***. Both the Target/selling corporation and the buying/Acquiring corporation in an asset sale are required to file an "Asset Acquisition Statement" on IRS Form 8594 with their tax returns for the taxable year that includes the purchase date.[11] Form 8594 promotes consistent tax treatment reporting by both the buyer and the Target/seller.

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[11] Reg. §1.1060-1(e)(1)(ii)(A).

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(a) **Form 8594**. Form 8594 requires a statement of: (i) aggregate fair market values of each class of assets, (ii) allocation of the purchase price among the seven classes of assets, (iii) whether the buyer and Target/seller have an agreement on the allocation, and (iv) whether the buyer had purchased a license, covenant not to compete or entered into a lease agreement, employment agreement, management contract or other similar arrangement with the Target/seller, and if so, the maximum amount to be paid under such agreement.

(b) **Filings For Later Adjustment to Purchase Price**. If there is a subsequent adjustment to the purchase price in a later taxable year, the party making the adjustment must file a supplemental asset acquisition statement on Form 8594.[12]

(c) **Penalties for Failure to File**. If a taxpayer fails to file Form 8594, the taxpayer is subject to civil penalties under §§6721 through 6724.

3.8 ***Tax Consequences of Allocating Purchase Price in an Asset Sale to Different Classes of Property***.

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[12] Reg. §1.1060-1(e)(1)(ii)(B).

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(a) **<u>Allocation to Tangible Personal Property</u>**. The portion of the purchase price allocated to tangible personal property such as equipment, furniture and machinery is a Class V asset under §1060. The buyer will then amortize the purchase price of such personal property over the shorter recovery periods of five to seven years under §168(c) using the double declining method. The Target/seller will recognize no income to the extent of its tax basis in the sold personal property and will recognize ordinary income to the extent of any §1245 recapture. If the seller is a pass-through entity (such as an S corporation or an LLC), then the difference between capital gain and ordinary income tax rates on §1245 recapture will be important. Allocations of the purchase price to personal property may be subject to state sales and use tax.

(b) **<u>Allocation to Real Estate</u>**. Generally, the buyer/acquirer will wish to avoid allocations to real estate since the recovery period for real estate improvements is much longer than personal property (39 years straight-line for non-residential real estate under §168(c)) and amounts allocated to land cannot be depreciated. For pass-through entities (such as S corporations and LLCs) the Target/seller may prefer an allocation to real estate in order to tax the selling entity (and the resulting pass through of gain to its shareholders) at lower capital gains rates (except for the real estate recapture portion which is taxed at a 25 percent

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tax rate). Allocations to real estate in an asset sale may require the payment of a local documentary transfer tax when the deed is recorded.

(c) **Allocation to Inventory**. A buyer may try to allocate more of the purchase price to inventory in order to increase the buyer's future "cost of goods sold" deduction and thereby reduce the buyer's future ordinary income when the inventory is sold. The Target/seller, to the extent of its tax basis in the inventory, will recognize no gain.

4. USE OF EMPLOYMENT AGREEMENTS, MANAGEMENT AGREEMENTS AND CONSULTING AGREEMENTS IN AN ASSET SALE OR A STOCK SALE.

Buyers of businesses (whether purchasing stock or assets), in order to immediately expense payments in the year of payment (as a §162 deduction) and to avoid §197 (15-year amortization), may try to characterize a portion of the purchase price as compensation under an employment, management or consulting agreement.

4.1 ***Tax Effect on the Selling Shareholder***. Payments made to the selling shareholder under employment, management or consulting agreements are deductible by the buyer/Acquiring entity as §162 expenses in the year of payment and are includable by the recipient (i.e., the selling shareholder) in the year of receipt.

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The recipient (employee, manager or consultant) of these payments will be taxed at ordinary income rates instead of lower federal capital gain rates, but the Target selling shareholder avoids a double level of taxation by receiving monies directly. Additionally, an employment agreement or consulting agreement may produce employment taxes to the employee (and to the buyer/employer), and may affect social security benefits to a selling shareholder/employee.[13]

> **PLANNING IDEA**: **The Selling Shareholders Use Qualified Plans to Defer the Sellers' Income Taxes**. Selling shareholders can set up a consulting corporation with a qualified deferred compensation plans to defer the tax on an employment or consulting agreement's payments. The qualified plan's earnings on monies held in the qualified plan will be tax exempt.

4.2 ***Reporting of Employment and Consulting Agreement to the IRS***. In a business acquisition, the employment and consulting agreement must be reported to the IRS on Form 8594, including the maximum amount of consideration paid thereunder.

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[13] Salaries will be subject to the FICA tax (sometimes known as Old Age Survivors and Disability Insurance Tax) to both the paying (employer/buyer) and recipient (employee/selling shareholder) to the extent of the maximum wage base. The tax rate is 6.2% to both the employer and employee on the first $102,000 of wages in 2008. This wage base was $51,300 in 1990. Additionally, there is the Medicare hospital insurance portion of the FICA tax resulting in a tax rate of 1.45% to both the employer and employee for all wage payments with no minimum base. [§§3111(a) and 3101(b).]

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4.3 ***<u>In Order for an Employment or Consulting Agreement to Be Recognized For Tax Purposes, do the Following Items</u>***. To validate an employment or consulting agreement for tax purposes (including that the compensation paid is reasonable) the parties should <u>recite</u> in their employment and consulting agreement documents <u>and have evidence</u> of the following factors[14]:

(1) the expertise and skills of the shareholder/employee that will contribute to the business, and why the employee is valuable;

(2) the fact that the employee's presence is important to make contacts with customers;

(3) the fact that the employee/shareholder's presence is necessary to make an orderly transition of the business;

(4) the fact that during the employment agreement the seller/employee may not compete or damage the business of the buyer;

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[14] See the Tax Court case of ***Wechsler & Company***, TC Memo 2006-173, for a discussion of factors to determine reasonable compensation.

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(5) the amount of the Seller/employee's compensation compared to the compensation of similar employees in comparable businesses;

(6) that the employment/consulting agreement is negotiated separately from the main asset purchase agreement;

(7) that the shareholder/employee is required to spend a specified number of hours per week in the business; and

(8) the employee/Target shareholder has a separate attorney other than the attorney for the Target corporation.

Not every one of the above factors needs to be satisfied. These factors will be weighed by the IRS to determine whether the employment relationship should be recognized for tax purposes.

4.4 ***Business Points Important to the Target Shareholder/ Employee in an Employment/Consulting Agreement***. The Target selling shareholder/employee will want the consideration under the employment/consulting agreement to be guaranteed and to be paid, even if the employee is disabled or dies, or his services are terminated for any reason. In other words, the employee/seller may expect to receive the employment/consulting agreement's payments

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whether or not the employee is providing services. Consider the use of a deferred compensation plan.

Should the employment agreement be secured by a UCC-1, guarantee or letter of credit? Should there be personal guarantees for an employment agreement? These items protect the continual payment of compensation to the seller/employee, but for tax purposes these items make the employment agreement appear more like a promissory note than an employment agreement.

4.5 ***Avoiding the Golden Parachute Rules*.** Clients should structure any compensation agreement to avoid the punitive taxes of the "golden parachute rules" of §280G. Exceptions to these Golden Parachute taxes include: (i) payments by S corporations; and (ii) payments by corporations with no publicly traded stock where 75 percent of shareholders approve the payments. §280G(b)(5).

5. AVOID THE DOUBLE LEVEL OF TAXATION TO A C CORPORATION ON AN ASSET SALE BY TREATING PART OF THE PURCHASE PRICE AS A PAYMENT FOR ASSETS OWNED BY THE SHAREHOLDERS

The C corporate level of tax can be avoided in an asset sale by the buyer paying to the selling/Target's business's shareholders directly (and not to the selling/Target corporation):

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(i) a license fee for shareholder owned trademarks, trade names, or franchises;

(ii) rent or a purchase price for real estate owned by the selling shareholders;

(iii) payments for goodwill owned directly by the selling shareholders; and

(iv) payments to the selling shareholders for covenants not to compete.

5.1 ***License Fees Paid Directly to the Selling Shareholders***. License fees are taxed to the receiving selling shareholders at ordinary income rates (currently a maximum 35 percent federal rate plus California tax), while the buyer is able to amortize the costs of the purchased franchises, trademarks and trade names over 15 years under §197(d)(1)(F).

5.2 ***Payment to Selling Target Shareholders For Real Estate Owned By the Shareholders***. Shareholders owning the business's real estate can either sell that real estate to the buyer (receiving capital gain treatment on sale with the exception of recapture income), or the shareholders can rent that real estate to the buyer

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(where the shareholder receives rents taxed at ordinary income rates).

5.3 ***Selling Target Shareholders Can Sell to the Buyer Goodwill Which is Owned Directly By These Selling Shareholders***. If the business's "goodwill" is owned by the selling Target shareholders directly (instead of by the selling Target corporation), then the selling shareholder can sell that goodwill directly to the buyer at lower long-term capital gain rates and also avoid a corporate level tax on the goodwill's sale.

For example, in ***Norwalk***[15] the Tax Court held that the sold goodwill of an accounting practice was in fact owned by the individual accountant selling shareholder and not by the accountant's professional corporation. Thus, in the liquidation of the accounting corporation, the corporation did not recognize taxable gain on the distribution of that goodwill.

Similarly, in ***Martin Ice Cream Co.***[16] the Tax Court held that the individual selling shareholder had a personal relationship with

[15] TCM 1998-279.

[16] 110 T.C. 189 (1998). For a case where the taxpayer failed to prove personal goodwill see ***Muskat***, 101 AFTR2d 2008-1606 (DC of New Hamp., 2008). Also see ***Solomon***, TC Memo 2008-102, where the taxpayer failed to show personal goodwill and instead found that the goodwill was that of the corporation's business processing, manufacturing and sales.

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customers in the sold "goodwill," and thus this sold goodwill was owned by the selling Target shareholder and not by the Target corporation. An important fact in ***Martin Ice Cream Co.*** was that the shareholder did not sign a non-competition agreement nor an employment agreement previously with the Target corporation. The shareholder had a relationship directly with the customers.

In doing an allocation to personal goodwill of the shareholder, it is helpful if an appraisal of that personal goodwill is obtained. Also, if in the asset sale the shareholder must sign a separate non-competition agreement and/or a separate consulting agreement, then you must be prepared to justify the amount of consideration being allocated to such non-competition agreement and consulting agreement. It is important that the selling shareholder be able to prove that they have the personal goodwill directly with the customers. It is helpful if the shareholder can prove their expertise, business relationship with customers, and other factors showing the personal goodwill that exists. If the Target/selling corporation consists of multiple shareholders, then you should avoid allocating the personal goodwill proportionately among the multiple shareholders' shareholdings, since this will evidence that the payments are actually dividend distributions to the shareholders. Instead, where there are multiple shareholders, the preference is that only

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one or a few of those shareholders has the personal goodwill (and are able to prove same by their customer relationships).

Remember that the Acquiring corporation will have to amortize the payments for the personal goodwill over a 15-year straight-line method under §197.

5.4 ***Covenant Not to Compete Payments Paid Directly to the Selling Target Corporation Shareholder***. A covenant not to compete can run directly to the Target shareholder. See discussion at paragraph 7.1, below. In situations where the shareholders of the selling Target corporation own the "goodwill," then payments for covenants not to compete can go directly to those shareholders, thus avoiding a C corporate level tax.

6. USING PASS-THROUGH ENTITIES TO AVOID THE C CORPORATION DOUBLE LEVEL OF TAXATION

A common problem is that many businesses are currently owned in C corporation form, which can subject those C corporation business sales proceeds to a double level of taxation.

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Owning the business in a pass-through entity such as a limited liability company[17] or S corporation avoids the double level of taxation. S corporations still have a 1.5 percent California tax on its earnings, including gain on an asset sale.[18] This 1.5 percent California corporate tax on the income of S corporations also applies where the S corporation receives back an installment note, and will be applied in the year of the S corporation's dissolution or as soon as monies are paid on the installment note.

6.1 ***Tax Rates Favor the Use of a Pass-through Entity If the Assets of a Business Are Sold***. In certain situations, it may be advantageous to utilize a C corporation instead of a pass-through entity, since a C corporation can compound earnings taxed at the lower maximum corporate tax rates (assume a 34 percent maximum federal corporate tax rate and an 8.84 percent California corporate tax rate). The appreciation in the value of the C corporation (with its earnings) can then be realized through the sale of its stock at lower capital gain rates (assume a maximum 15 percent federal tax rate and a maximum 9.3 percent California tax rate).

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[17] California imposes an annual tax of $800 as a franchise tax on limited liability companies, plus an annual LLC fee on income (before deductions) of $900 on income of $250,000, which fee maximizes at $11,790 annually on $5,000,000 of income. See §17941 of the California Rev. and Tax. Code.

[18] See §23802(b)(1) of the California Rev. and Tax. Code.

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However, this tax analysis may actually favor using a pass-through entity (and not a C corporation) when taking into account that C corporate earnings can be eliminated by paying deductible compensation to shareholders, and the fact that appreciation in the goodwill and other corporate assets in a C corporation subjects that appreciated goodwill and assets to a double level of taxation in an asset sale of the business. Accordingly, in the case of a closely held business, because much of the business's value is represented by appreciated goodwill, a pass-through entity may produce a better tax result than would a C corporation.[19]

6.2 ***Spinning Off Part of the C Corporation's Business to a Pass-through Entity to Avoid a Double Level of Taxation***. If the business is not currently owned in a pass-through entity (and is instead owned by a C corporation), then prior to the business's sale clients can consider "spinning off" a business opportunity of the C corporation's business to either an S corporation or to a limited liability company to avoid the double level of taxation.[20] For example, if the client is developing a new manufacturing division or a new product line, the client can form an LLC or S

[19] Some practitioners argue that a C corporation's future income can be substantially reduced by paying a qualified dividend taxed at a 15% rate. However, this 15% qualified dividend tax rate may expire in the future if Congress decides to raise or eliminate this rate, plus the corporate level tax will generate a greater amount of tax on a dividend distribution than if a pass-through entity is utilized.

[20] In order for a formal spinoff to be a tax-free reorganization, the spinoff must qualify as a D reorganization, which may be difficult because of the technical requirements of §§355 and 368.

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corporation to own this new division. The IRS would be hard pressed to impose a constructive dividend on the allocation of the corporation's opportunity to such new pass-through entity.[21]

The IRS might try to attack this plan under §482 and reallocate income between the new entity and the old entity.

Prudent tax planning dictates that any such "spin off" occur <u>well in advance</u> of the business's sale and <u>not</u> be part of a prearranged plan to sell the business.

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[21] See District Court case of ***McCabe Packing Co***., 71 AFTR 2d 93-672, in which the Federal District Court rejected an IRS claim of a constructive dividend where a corporation distributed a business opportunity to one of its officers.

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PLANNING IDEA: **Have the Existing C Corporation Transfer Its Assets to a Limited Liability Company or a Limited Partnership and Then Convert to an S Corporation, in a So-called "Downstream Drop" of Assets**. An existing C corporation can transfer some or all of its operating assets "downstream" to a limited liability company or to a limited partnership and receive back limited liability company membership interests or limited partnership interests. The general partner (or manager in the case of a limited liability company) can be either a new entity controlled by the former principal shareholders or trusts for family members. This planning technique allows the transfer of value to other family members (in the form of gifted or sold limited partnership or membership interests). This planning technique also allows some of the C corporation income to be shifted to lower tax bracket family members.

This C corporation can later convert to an S corporation and minimize the §1374 built-in gain tax of §1374, since the limited partnership interests (owned as an asset of the newly converted S corporation) can be discounted for purposes of the built-in gain calculation under §1374.

6.3 ***Convert a C Corporation to an S Corporation, But Remember Section 1374 Built-in Gains Tax***. If a C corporation is converted to S status, then there is a potential built-in gains tax under §1374. Section 1374(a) imposes a corporate level federal tax at the highest §11 rate (currently 35%) within the recognition period on the "net recognized built-in gains" (which are gains from the C corporation years) of S corporations. Like other items of S corporation income and gain, net recognized built-in gain passes through and is taxed to the shareholders. [§1366(a)(1).]

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The §1374 built-in gain "recognition period" is the 10-year period beginning with the first day of the first taxable year for which the corporation is an S corporation. [§1374(d)(7).] There is a presumption that all gains recognized within the recognition provision are subject to §1374 unless the S corporation can prove otherwise.

The tax on net recognized built-in gains applies only to S corporations which were previously C corporations. Therefore, if a corporation elects S corporation status upon its formation, §1374 will not apply. [§1374(c)(1).] An exception to this rule is where a corporation, which was always an S corporation, acquires assets from a C corporation in a tax-free transaction.

6.4 ***Avoiding the Built-in Gains Tax On the S Corporation***. If an S corporation has been in existence for 10 years or more (or was initially formed as an S corporation and not as a C corporation), then the §1374 built-in gains tax on the asset sale will not apply.

PLANNING IDEA: **Obtain an Appraisal When Making an S Election**. If your client converts a C corporation to an S corporation then the client should obtain an asset appraisal in order to prove the fair market value of the S corporation's assets on the date of the S corporation election.

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7. HOW TO TREAT SECTION 197 INTANGIBLE ASSETS IN THE SALE OF A BUSINESS'S ASSETS

Section 197 requires that in the purchase of a business's assets the buyer ratably amortize over a 15-year straight-line period the costs of acquiring intangibles such as goodwill, customer lists, subscription lists, books, records, patents, copyrights, know-how, and covenants not to compete. Although §197 generally only applies to asset purchases, it may also affect the sale of partnership interests, or can affect stock purchases or redemptions where covenants not to compete are utilized.

7.1 ***Buyer's Payments For Covenants Not to Compete and For Goodwill***.

(a) **Tax Treatment**. The shareholder of a Target/selling corporation receiving payments for a covenant not to compete will report these payments as ordinary income in the year of receipt.

Payments for covenants not to compete are not deemed to be the carrying on of a trade or business, and thus will not be subject to self-employment taxes.[22] However, a consulting or employment agreement payment will be subject to self-employment tax.

[22] See ***Herbert Barrett***, 58 TC 284 (1972), acq. in result 1974-2 CB1.

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Accordingly, payments for covenants not to compete should be segregated from those payments for consulting and employment agreements, and should be done under a separate written agreement.[23]

Payments received by selling shareholders for covenants not to compete avoid a double level of taxation for C corporations. The buying corporation must amortize those payments it makes for the covenant not to compete over a 15-year straight line period under §197 (even if the covenant not to compete lasts for a short time period such as five years). [§197(d)(1)(E).]

(b) **Covenant Not to Compete Versus Goodwill**. The required 15-year amortization period also applies to the buyer's payments for goodwill. However, for a selling pass-through entity (such as an LLC or S corporation), the seller has an incentive to allocate more of the purchase price to goodwill (which is taxed to the selling pass-through entity's owners at the lower capital gains tax rates with one level of taxation), rather than to a covenant not to compete (which is taxed to the seller at higher ordinary income tax rates).

7.2 ***Payments For Information Based Assets***. These are §197 intangibles such as business books and records, operating systems

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[23] See, for example, ***Norman Erickson***, TC Memo 1992-585, aff'd 1 F3d 1231 (1993 CA1).

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and any other information based lists or information of current or prospective customers. Examples would be technical manuals, training manuals or programs, data files, accounting and inventory control systems, customer lists, subscription lists, insurance expirations, and patient and client files. [§197(d)(1)(C).] As a §197 asset, the purchase price allocated to these intangibles must be amortized by the buyer over 15 years.

7.3 ***Payments For Leases***. Very often the Target/seller will have a favorable real property lease (e.g. rents paid by the Target at rental rates less than fair rental value) which is being assigned to the buyer as part of the sold assets. The excess value between the fair rental value and the actual rent paid under the lease can be "sold" as an asset. This asset value being purchased by the buyer is then amortized by the buyer over the remaining term of the lease.

If the buyer purchases real or personal property which is being leased for rents higher than fair rental value, then this sold lease value must be amortized by the buyer over the life of the purchased property. For example, if there are high-rent leases of a shopping center, that portion of the acquisition price attributable to these high-rent retail store leases must be added to the buyer's tax basis in the purchased shopping center and then

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amortized by the buyer over the 39-year straight line period of the shopping center real estate.[24]

7.4 ***Payments For Patents***. Patents may present an income stream in the form of royalties over a specified number of years (or may be one lump sum payment). Patents can represent technology (such as a trade secret) being purchased by the buying corporation.

Patents are not amortized over 15 years if they are sold separate from the sale of a business. [§197(e)(4)(c).] For patents purchased separate from a business's sale, the buyer must depreciate the basis in the purchased patent ratably over the patent's remaining life. [Reg. §1.167(a)-14(c)(4).]

If the purchase price of a patent is payable on an annual or more frequent basis as either a fixed amount per use or a fixed percentage of the revenue, such annual payment amount is deducted each year by the buyer.

> **Example**: Assume that Bill, in selling his auto parts manufacturing company to Horton, Inc., receives from Horton, Inc. in exchange for trade secrets license payments each year. Provided that these license payments

[24] See Revenue Reconciliation Act of 1993, Conference Report at 681-682.

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are reasonable for the use of the licensed trade secrets, the license payments will be respected and will not be classified as a §197 asset. According, the license payments paid by Horton, Inc. will be currently deductible by Horton, Inc. as paid. [§197(e)(3)(A)(i); and Reg. §1.197-2(c)(4)(i).]

7.5 ***Payments For Franchises, Trademarks and Trade Names***. Purchase price costs of franchises, trademarks and trade names are included as a §197 intangible to be amortized over 15 years. [§197(d)(1)(F).] However, the buyer can still apply the rules of §1253(d)(1) to currently deduct payments that are contingent on the productivity, use or disposition of a franchise, trademark or trade name, if such payments are part of a series of payments that are paid at least annually throughout the term of the transfer agreement. [§§197(f)(4)(C); 1253(d)(1)(B).]

Example: Big Burger is a franchiser of retail hamburger shops. Al enters into an agreement with Big Burger to own and operate a retail Big Burger outlet on the corner of Sepulveda Boulevard and Santa Monica Boulevard, using the Big Burger trademark and trade name. Al agrees to pay Big Burger $100,000 upon the execution of the franchise agreement, as well as a specified percentage of the gross sales. Because the acquisition of a franchise

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is considered to be the acquisition of an interest in a trade or business, the franchise is not considered acquired separately. Therefore, the $100,000 lump-sum franchise fee paid by Al is a §197 intangible asset and must be amortized by Al over 15 years. However, Al's franchise payments, which are based upon gross sales, are not §197 assets and can be deducted as paid because these payments are serial contingent payments as defined in §1253(d). [Reg. §1.197-2(b).]

Example: McClain, Inc. purchased for a lump sum payment a patent from Lolich, Inc. McClain, Inc. also purchased the right to use a trade name from Northrop, Inc. Because the patent was not acquired as part of the purchase of a trade or business, it is not a §197 intangible and its purchase price can be amortized over the remaining life of the patent. However, the Northrop, Inc. trade name, even if not purchased as part of a trade or business, constitutes a §197 intangible asset, and the lump sum payment paid for it must be amortized over the 15-year period. [Reg. §1.197-2(b).]

7.6 ***Assets Excluded From the 15-Year Amortization Requirements of §197***. Section 197(e) excludes certain assets from its required 15-year amortization. Some of the more important

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exclusions are: certain computer software; interests in film, sound recordings, video and books not involved in the acquisition of a trade or business; any interest under an existing lease of tangible property; and professional sports franchise. Thus, if computer software is part of the assets of the sold business, the software licensing payment amount can be currently deductible by the buyer so long as the software is of is a type that is readily available for purchase by the general public.

7.7 ***Specific Items Which Are Not §197 Intangibles***. The regulations list the following items as not a 197 intangible asset:

(a) Stock interests in a corporation, partnership interests, and beneficial interests in a trust or an estate. Therefore, costs of acquiring stock, partnership interests or interests in a trust or estate cannot be amortized, as a §197 asset. [Reg. §1.197-2(c)(1).]

(b) Interests in land, life estates, remainder interests, timber rights, farm allotments, zoning variances and similar rights cannot be amortized as a §197 asset. [Reg. §1.197-2(c)(3).]

7.8 ***How to Calculate the 15-Year Amortization Under §197***. The amortization deduction is computed by amortizing the §197

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intangible asset ratably over a 15-year period beginning on the later of the first day of the month in which the property is acquired or in the case of property held in connection with the conduct of a trade or business, the first day of the month in which the active conduct of the trade or business begins. [Reg. §1.197-2(f)(1).] The basis to amortize is determined under §1011, and salvage value is disregarded.

If there are additional amounts paid by the buyer after the business's sale closes, then these additional amounts are added to the intangible asset's tax basis during the 15-year period (e.g. additional amounts are paid for a covenant not to compete during the 15-year period after the business's sale closes). The result is that these additional post-closing payments, which are added to the assets' tax basis, are then amortized ratably over the remainder of the asset's 15-year amortization period.

Amounts paid by the buyer after the expiration of the 15-year period are immediately deductible by the buyer.

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8. SECTION 453 INSTALLMENT SALES OF ASSETS AND NON-PUBLICLY HELD STOCK

Shareholders, instead of receiving cash for the sale of their business (which is taxed in the year of receipt), may spread their sale's gain over several years by receiving back an installment promissory note.[25]

Shareholders may receive an installment obligation for a corporation's asset sale in a 12-month complete corporate liquidation and not have the note's gain accelerated for federal income taxes.[26] [See §453(h)(1).] However, upon the distribution of an installment note in a corporate liquidation, the income on the installment note is accelerated for California corporate income tax purposes. [§24672 of California Rev. and Tax. Code.]

S corporations are subject to the 1-1/2 percent California tax on the income from an installment note in the year of the S

[25] An installment note is permitted to defer gain recognition for either a non-publicly held stock sale by the shareholders or an asset sale by the Target corporation.

[26] If the installment note is not from a sale or exchange within the 12-month corporate liquidation period, then the distribution of the installment note from the corporation to the shareholder will trigger the installment note's deferred gain under §453B(a).

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corporation's dissolution or as soon as monies are paid on the installment note.[27]

Installment notes can be secured by qualifying standby letters of credit or by the sold business's assets.[28]

Even if a sale is eligible for installment sales treatment, the selling corporation may elect out of §453 treatment and recognize all of the gain in the first year. [§453(d).]

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[27] See §24672 of the California Rev. and Tax. Code.

[28] Temp. Regs. §15A.453-1(b)(3)(i). The letter of credit to qualify must be non-negotiable and non-transferable (except together with the installment note).

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PLANNING IDEA: What If the Buying Entity is Willing to Pay the Selling Shareholders All Cash For Their Stock, But the Shareholders Still Wants to Defer Their Stocks' Sales Gain Over Several Years By an Installment Note? One tax planning strategy is for the selling shareholders to first sell their stock to an unrelated (but trusted) independent entity in exchange for an installment note.[29] It is preferable to do this first sale by an installment note to the unrelated third party well in advance of the second sale. This third-party entity then sells the shareholders' stock to the buyer for all cash, recognizing no capital gains since this third party's tax basis in the sold stock equals the amount of the installment note by which the stock was purchased from the selling shareholders.

The third-party entity receives, controls and invests the stocks' sale proceeds. By this plan the selling shareholders are able to defer their stocks' gain by the installment note payments over several years, rather than recognizing all of their gain in the first year.

Tax issues to keep in mind are: (i) IRS assertions of selling shareholder's constructive receipt of the third party's received monies; and (ii) avoiding the third party being classified as the selling shareholder's agent for tax purposes.

8.1 ***Stock Sale***. A non-publicly held stock sale would be a sale of a capital asset qualifying for installment sales treatment under §453.

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[29] Under §453(e), if there is a stock sale to a related party by an installment note, and that related party then sells that stock within two years after the first sale, the amount received by the related party on the second sale is treated as a payment made on the installment note. Accordingly, if §453(e) applies then this planning strategy will not work.

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8.2 ***Using Installment Notes With an Asset Sale***.

(a) **Installment Sales Rules Are Applied on an Asset-by-Asset Basis**. Section 453 does not apply to the sale of the following assets: assets on which the selling corporation has a loss [§453(a)]; recapture income [§453(i)][30]; publicly traded stock [§453(k)]; or inventory (other than a bulk sale). [§453(b)(2)(B).] If there is an installment sale of assets, §453 is applied on an asset-by-asset basis, and not as to an aggregate sale of the business. [See Rev. Rul. 68-13, 1968-1 C.B. 195.]

[30] The term "recapture income" means the amount of gain that would be treated as ordinary income under §§1245 or 1250. It does not include "unrecaptured §1250 gain" which is the §1250 gain from real estate taxed at the 25% rate. [§1(h)(1)(D).]

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PLANNING IDEA: **In the Purchase and Sale Agreement of Assets, Have a Provision Which Allocates the §453 Installment Note to Only Assets Qualifying For §453 Treatment**. The Purchase Price received by the seller must be allocated between all of the sold assets under §1060. The cash portion of the purchase price received by the seller can be allocated to those assets not eligible for installment sales treatment (such as assets with recapture or publicly-held stock), and the §453 installment note can be allocated to those assets that are eligible for §453 treatment. [See Rev. Rul. 68-13, 1968-1 C.B. 195.]

There is no authority to prevent allocating the §453 installment note to only those assets qualifying for §453 treatment. Prior to the enactment of §1060, the buyer and seller could allocate cash and §453 payments in a non-pro rata manner [See Rev. Rul. 76-110, 1976-1 C.B. 126].

8.3 ***Seller is Required to Pay Interest on the Amount of Tax Deferred For Installment Note in Excess of $5,000,000***. One disadvantage of a §453 installment note is that if all of the installment sale notes paid to the seller for the taxable year exceed $5,000,000, interest must be paid to the IRS on the installment notes' deferred tax liability for the installment rates' amounts in excess of $5,000,000. [§453A(a).] Accordingly, if the §453A $5,000,000 limitation applies, then the seller should receive enough monies to enable the seller to make the tax interest payments to the IRS.

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9. USING A CHARITABLE REMAINDER TRUST TO AVOID TAX ON THE GAIN FROM THE SALE OF A BUSINESS

A charitable remainder trust ("CRT") allows selling shareholders to contribute some or all of their business's stock to the CRT, receive a current charitable income tax deduction equal to the actuarial value of the charity's remainder interest. The CRT can then sell the stock effectively income tax free. Thereafter, the CRT pays an annuity amount each year to the client from the CRT's sales' proceeds for the seller/client's life or stated term.[31] Upon the client's death or the end of the CRT's stated term, the remaining CRT assets pass to the client's chosen charity.

The establishment of the CRT and transfer of the stock to the CRT should be completed well in advance of the business's sale, and before a purchase agreement or letter of intent is signed. If stock is contributed by the client to a CRT or to a charity, and by "prearrangement" the corporation stock is to be redeemed or sold, then the IRS may treat the sales proceeds as income taxed to the

[31] The tax character of CRT distributions to the client/trust beneficiary is determined by an ordering rule under which each trust payment to the client trust beneficiary is taxed in a specified order. Reg. §1.664-1(d). As an example, if the stock's sales proceeds are invested by the CRT in tax-exempt bonds, then the annual CRT payments to the client/beneficiary will be taxed at capital gains rates. The capital gain rates represent the deferred capital gain from the CRT's sale of the stock.

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client, rather than as taxable income to the CRT or charity, under assignment of income principles.[32]

9.1 ***Use a Charitable Remainder Trust to Transfer Business Ownership to Children***. A CRT can be used to transfer a business from parents to children by combining the CRT with the redemption of the corporation's stock.

> **PLANNING IDEA**: **Using a CRT to Transfer Ownership to Family Members**. The parents first establish a CRT. The parents then transfer a portion of their corporate stock (such as 60%) to the CRT and receive a charitable income tax deduction. The CRT then distributes an annuity each year to the parents (such as structuring the CRT as a unitrust). Since after the transfer of stock to the CRT the parents own a minority amount of the corporation's shares (40% in this example), this minority interest is entitled to a discount for lack of control and lack of marketability. The parents' 40 percent interest with its valuation discount is then gifted to the children. Several years later the shares owned by the CRT are redeemed by the corporation. The corporation obtains the monies for this share redemption from its retained earnings and from a bank loan.
>
> The result of this tax plan is that the children end up being the sole shareholders of the corporation. The CRT holds and invests the proceeds of the stock redemption, and these invested proceeds will then pass to the remainderman charity upon the deaths of the parents.

[32] See Rev. Rul. 78-197, 1978-1 CB 83; and ***Ferguson***, 83 AFTR 2d 99-1775 (CA 9, 1999).

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10. USE OF CORPORATE TAX-FREE REORGANIZATIONS IN THE SALE OF A BUSINESS -- HOW SELLING SHAREHOLDERS CAN ENTIRELY AVOID TAX ON THE SALE OF THEIR BUSINESS

If the Target/selling corporation (or its shareholders) receive stock in the Acquiring/buying corporation in exchange for the transfer of the selling shareholder's shares or assets, generally there is no recognition of gain under the tax-free reorganization rules of §§354-368. The reason that no gain is recognized is that the new stock received (stock in the Acquiring/buying corporation) is a continuation of the "old investment" of the stock in the Target/selling corporation. In order for a transaction to qualify as a tax-free reorganization, it must satisfy the statutory requirements of being a "reorganization" under §368. Additionally, the transaction must also: (i) have a business purpose; (ii) satisfy the continuity of interest rules; and (iii) satisfy the continuity of business enterprise rules.

In a tax-free reorganization, the selling shareholder's taxable gain in their stock is deferred by the selling shareholders having a substituted tax basis in their received buying corporation's stock, which equals the basis of the selling

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shareholder's shares, with certain adjustments.[33] However, gain will be recognized by the Target/selling shareholders if they receive, in addition to stock or securities, cash, or other consideration (i.e., "boot"). In such event, gain will be recognized to the extent of the boot received.[34]

Tax-free corporate reorganizations under §368 include mergers, consolidations, recapitalizations, acquisitions by one corporation of the stock or assets of another corporation, and the change in form or place of organization.

10.1 ***Tax Effect of Tax-free Reorganization on the Buyer and on the Seller***.

(a) **Effect of Tax-free Reorganization on the Target/Selling Shareholders**. The Target/selling shareholders are able to defer the tax on their received stock until that stock (which stock the sellers receive in the Acquiring/buying corporation) is sold. The tax can be completely avoided if the Target/selling shareholders holds the Acquiring/buyer's stock until

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[33] See §358. The selling shareholder's received stock's basis is the same as that of the selling shareholder's stock exchanged and is decreased by "boot" received by the selling shareholder and increased by amounts treated as a dividend and the amount of recognized gain by the selling shareholder.

[34] Certain forms of reorganizations limit or prohibit the amount of non-stock (or "boot") consideration which the seller can receive.

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the death of the selling shareholder or their spouse. Gain from the seller's receipt of cash or other "boot" in the exchange, whether treated as qualified dividend income or capital gains will still be taxed at the maximum 15 percent federal rate.[35]

(b) **Effect of Tax-Free Reorganization on the Acquiring/Buying Corporation**. The Acquiring/buying corporation does not receive a step-up in the tax basis of the Acquiring corporation's assets. [§362(b).] However, the buying corporation can utilize the buyer's own stock to purchase the seller's business (instead of using cash), which in many cases proves to be a significant economic advantage to the buyer in acquiring the seller's business.

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[35] See §356. Section 1(h)(11) taxes qualified dividend income at a maximum 15% rate.

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PLANNING IDEA: **Have Selling Shareholders Use an Exchange Fund to Diversify Their Stock Holdings After the Tax-free Reorganization.** One drawback of a selling shareholder receiving a large number of shares in the Acquiring/buying corporation is that this leaves the selling shareholder with stock ownership concentrated in one large block of stock. Lack of diverse stock ownership makes the selling shareholder susceptible to a decline in that one stock's value.

A solution to diversify the sellers' stock holdings is for the selling shareholder to contribute their stock (which they receive from their business's sale) to an "exchange fund" established by a brokerage house or investment fund. An exchange fund is generally structured as a partnership (or LLC) where different investors contribute large blocks of each investor's publicly traded stock into the exchange fund in order to diversify stock ownership among the various contributed stocks.

10.2 ***Types of Tax-Free Reorganizations***. The various types of tax-free reorganizations are summarized below.

(a) **"A" Reorganization**. A statutory merger or consolidation. Involves filing with the appropriate state offices of the Acquiring and Target/selling corporation certificates of merger, along with changes in share ownership to the Target/selling corporation's shareholders.

(b) **"B" Reorganization**. Acquisition by the Acquiring/buying corporation by issuing the buying corporation's shares to the Target/selling corporation's shareholders, in exchange for the Target/selling corporation's shares. The result

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is that the selling corporation becomes a subsidiary of the buying corporation.

(c) **"C" Reorganization**. Acquisition by the Acquiring/buying corporation in exchange for the buying corporation's shares, of substantially all of the assets of the Target/selling corporation. The selling corporation then owns the buying corporation's shares and distributes these buying corporation's shares to the selling corporation's shareholders.

(d) **"D" Reorganization**. A transfer by the Target/selling corporation of one of its trades or businesses to a group of its shareholders, by distribution of such trade or business to another corporation followed by the distribution of stock of the other corporation to the selling corporation's shareholders.

10.3 ***Use of a Single Member LLC or Subsidiary Corporation to Protect Acquiring/Buying Corporation From Target's/Seller's Liabilities***. Many times when an Acquiring corporation desires to acquire assets of a Target/selling corporation, the Acquiring corporation is concerned that the Target corporation may have either known or unknown liabilities which the Acquiring corporation does not want to assume or become liable for. One technique to avoid liability exposure is for the Acquiring corporation to first

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set up a subsidiary corporation or a single member LLC which then acquires the Target/seller's assets in the reorganization.

For example, the single member LLC (which is 100% owned by the Acquirer) could acquire all of the Target/selling corporation's operating assets in exchange for the Acquiring corporation's stock going to the Target in a C reorganization. The Target/selling corporation would then distribute the Acquiring corporation's shares to the Target's shareholders.

10.4 ***Use of a Single Member LLC in an A Statutory Merger***. The Acquiring corporation, to limit its exposure to liabilities of the Target/selling corporation, may choose to set up a single member LLC. The Target/selling corporation can then merge into this single member LLC in an A reorganization, with the Target/selling corporation's shareholders receiving stock in the Acquiring corporation. This merger would qualify as a statutory A merger.[36] In fact, under the Treasury Regulations, an Acquiring corporation can set up multiple single member LLCs and merge portions of the Acquiring/selling corporation into each LLC under the statutory A tax-free reorganization rules.

[36] See Regs. §1.368-2(b)(1).

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PLANNING IDEA: **Cashing Out Certain Target Shareholders in a Tax-free Reorganization**. In a situation where some of the selling shareholders want to receive stock while others wish to receive cash ("cash-out shareholders"), a statutory A reorganization can be structured as follows: First, the Acquiring/Buying corporation can have the Target/selling corporation merge into the Acquiring corporation (or one of its subsidiaries). Second, in the merger the Acquiring corporation can issue Acquiring corporation stock to those selling shareholders who desire to receive stock, while paying cash to the cash-out selling shareholders. Assuming the continuity of interest rules of §368 are satisfied (which generally requires that at least 40 percent of the Target/selling stock are exchanged for the Acquiring corporation stock), then the tax-free reorganization rules can be satisfied. The result is that the cash-out Target/selling shareholders would report taxable gain based upon the amount of cash they receive, while those Target/selling shareholders receiving Acquiring corporation stock receive tax-free reorganization treatment.

Note that if a B reorganization is utilized, then the Acquiring corporation's control of the Target corporation must be obtained solely for voting stock; and if a C reorganization is utilized, then the Target/selling corporation's assets must be acquired solely for voting stock. The "solely" for voting stock requirement of the C reorganization provisions has an exception that the Acquiring corporation may pay cash in addition to the voting stock as long as the voting stock is used to acquire at least 80 percent of the Target/seller's assets (measured by their gross fair market value).

10.5 ***Use of Subsidiary Corporations and LLCs in "Triangular Mergers"***. There are variations of the above §368 tax-free reorganizations where the Acquiring/buying parent corporation first sets up a subsidiary corporation. **For example**, the Target/seller can receive stock in the publicly held Acquirer/parent corporate

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buyer when merged into that Acquirer's subsidiary corporation (in a so-called "triangular" transaction).

(a) **Forward Subsidiary Merger.** As another example, an A statutory merger can be structured as a **"forward subsidiary merger"** by which the Target/selling corporation is merged into (and that Target/selling corporation disappears) a subsidiary of the Acquiring corporation (and such Acquirer's subsidiary corporation survives), and the Target/selling shareholders receive stock of the Acquiring parent corporation. [See §368(a)(2)(D).] Section 368(a)(2)(D) requires that substantially all of the Target/selling corporation's property must be acquired by the Acquiring corporation's subsidiary. The Acquiring corporation (or its subsidiary) can pay boot, subject to the continuity-of-interest limitations. Unlike the reverse subsidiary merger rules of §368(a)(2)(E) discussed below, the forward triangular merger rules allow nonvoting stock of the parent corporation to be used, along with cash and debt securities (limited by the continuity-of-interest rules).

(b) **Reverse Subsidiary Merger**. A **reverse subsidiary triangular merger** is structured where the Acquiring corporation sets up a subsidiary corporation, and that subsidiary corporation is then merged (and disappears) into the Target/selling corporation (which Target/selling corporation survives the merger) with the

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Target/selling corporation shareholders receiving Acquiring corporation stock. [See §368(a)(2)(E).] Under the reverse triangular merger rules of §368(a)(2)(E) the surviving Target/selling corporation must hold substantially all of the assets of both the surviving corporation (which is the Target corporation) and the subsidiary corporation (which is the subsidiary corporation of the Acquiring corporation). In the reverse triangular merger rules of §368(a)(2)(E), the voting stock of the Acquiring parent corporation must be exchanged for at least 80 percent control of the Target/selling corporation and the other 20 percent of the Target stock can be acquired for boot.

(c) **Using a Single Member LLC**. In another form of triangular merger, the Acquiring corporation can also utilize a single member LLC in a tax-free reorganization. For example, the Acquiring/buying corporation can first form a single member LLC. Second, this Acquiring corporation's LLC then acquires all of the Target/selling corporation stock from the Target/selling shareholders in a B reorganization in exchange for the stock in the Acquiring corporation (which Acquiring corporation's stock is transferred to the Target/selling shareholders). LLCs as subsidiaries may be more flexible than using corporate subsidiary entities. LLCs at later dates can issue different classes of membership interests and can be designed to be more flexible in their distribution provisions.

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10.6 ***Selling/Target Corporation Shareholders Must Carefully Evaluate the Risks of Owning Shares in the Buying/Acquiring Corporation***. Selling shareholders may prefer not to receive shares of the buying/Acquiring corporation because of the risk that these shares could decline in value. However, if the buyer is of a "blue chip" quality, then the seller may feel more comfortable in receiving the buyer's shares. If your client is considering taking back shares in another corporation, then you should review: financial statements; the corporation's annual reports; SEC filings; and other information on the buying/Acquiring corporation. You should also determine whether those shares are actively traded on a national securities exchange and whether there are restrictions (including securities restrictions) on those Acquiring shares' later resale.

11. USING ESOPS TO SELL A BUSINESS

An employee stock ownership plan ("ESOP") is a qualified plan under §401. A principal owner of a business can sell their shares to an ESOP with significant tax advantages.

The ESOP obtains the money to purchase the principal owner's shares by borrowing money from the corporation, and the corporation in turn borrows that money from a bank.

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Participants in the ESOP are the employees of the corporation. Each year monies from the corporation are paid to the ESOP as employee contributions to a qualified plan. These monies in turn are utilized by the ESOP to pay back the ESOP loan to the corporation and the bank. The employee contributions are deductible by the corporation as are certain dividends paid to the ESOP on the corporation's stock.

11.1 ***Establishing the ESOP***. A C corporation or an S corporation may establish an ESOP by the adoption of qualified plan documents. If an S corporation is utilized, then under current law the seller of the S corporation shares will not be entitled to utilize the rollover provisions of §1042.

11.2 ***Selling the Corporation's Shares to the ESOP***. The corporation's principal shareholders desire to sell their shares to the ESOP in order to obtain cash. The value of the shares are established by an independent appraisal, since an ESOP is not permitted to pay more than fair value for purchasing the shares. The corporation obtains the money (for the share purchase) by borrowing the money from a bank, and these loan proceeds are then lent to the ESOP by the corporation in order to enable the ESOP to purchase the shareholder's shares. The corporation makes annual tax-deductible contributions to the ESOP (based upon the employee

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wages) which the ESOP in turn uses to pay the ESOP's debt back to the corporation, and the corporation in turn pays back the bank.

11.3 ***<u>Deferral and Rollover of Gain to Shareholder</u>***. If the ESOP purchases at least 30 percent of the corporation's shares, then the selling shareholder can defer the taxation of the capital gain on the sale of their shares to the ESOP by the selling shareholder electing §1042. Basically, §1042 allows the selling shareholder to reinvest the stock sales proceeds (received from the ESOP) in <u>qualified replacement property</u> ("QRP") which is securities of other domestic operating companies. To utilize this rollover rule the QRP must be acquired within 15 months, starting 3 months prior to the sale of the stock to the ESOP.

QRP includes stock and fixed income securities in publicly traded companies that use more then 50% of their assets in an active business. Government and municipal bonds, REIT interests, certificates of deposit and mutual funds <u>do not</u> qualify as QRP.

One way to use the §1042 rollover provisions is for the selling shareholder to purchase fixed income qualified bonds in a publicly traded corporation. The selling shareholder can then borrow against these QRP bonds and then utilize the loan proceeds to invest in other investment assets in order to diversify their portfolio. Upon the selling shareholder's death, the tax basis of

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the bonds will receive a step-up from its previously low tax basis (because it represented a roll over from the former sale of the stock), to the bonds' then fair market value.

11.4 ***ESOP Must Cover Employee Participants***. A major business issue in deciding whether to establish an ESOP is that the shares held by an ESOP must be allocated among the ESOP participants (who are employees of the corporation), based upon the relative compensation of the employees. The result is that a wide spectrum of employees may end up being covered under an ESOP, a result which may conflict with the principal selling shareholder's business goals.

11.5 ***Producing Minority Valuation Discounts***. If more than 50 percent of the corporation's shares are sold to the ESOP, then the selling shareholder is left with less than 50 percent of the corporation's stock, which can produce a minority valuation discount for any shares left by the selling shareholder at death or for shares gifted to the selling shareholder's family.

12. CALIFORNIA STATE TAX ISSUES IN THE SALE OF A BUSINESS

In addition to the California state income and franchise taxes at the individual and corporate level, there are other California

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tax issues such as sales and use taxes, documentary transfer taxes for real estate, and property tax increases.

12.1 ***California Sales and Use Tax***. The California sales and use tax generally applies to an asset sale, but does not apply to a stock sale.

(a) **Occasional Sales Exemption to the Sales and Use Tax**. A sale of assets is "occasional" if: (i) it is not one of a series that, if made in California, would require a seller's permit; and (ii) the seller does not hold or use the property being sold for activities that, if conducted in-state, would require a seller's permit. [California Rev. and Tax. Code §6006.5(a) and California Reg. §1595(a).]

If a person who is not required to have a seller's permit makes a sufficient number of sales in scope and number to require the holding of a permit, then such sales are subject to the sales tax. If more than two sales of tangible personal property is made during any 12-month period, then the seller is a "retailer" and the sales tax applies (and the "occasional" sales exemption does not apply).

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Thus, to qualify as an "occasional sale," the business asset sale should be an "isolated transaction."[37]

Accordingly, where a business which is required to hold a seller's permit is sold, the sales tax will apply to the sale of personal property (subject to the exceptions described below).

(b) **Sale of Inventory**. The sales and use tax will not apply to the sale of inventory where that inventory is to be held by the buyer for resale.

(c) **Sale of Fixtures Attached to Real Estate**. The sales and use tax will not apply to a sale of fixtures attached to real estate nor to amounts paid for real estate leases.

(d) **Statutory Mergers Exempt**. The sales and use tax will apply to an asset sale or a C reorganization, but will not

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[37] A service enterprise's first two substantial sales of tangible personal property made within a 12-month period, can qualify as exempt occasional sales. Any subsequent sales within the 12-month period will be taxable unless otherwise exempt. [California Reg. 18 §1595.] Before this Regulation, a service enterprise could not use the "occasional sale exemption" for any sales of tangible personal property that it had used.

Generally, when service enterprises are sold, the sales tax applies to the gross receipts from the tangible personal property held or used in the enterprise's selling activities. Service enterprises would be such operations as hospitals, hotels, theaters, laundromats, car washes, transportation companies, and trucking companies.

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apply to a stock sale nor to a statutory A reorganization. [California Reg. 18 §1595(b)(3).]

(e) **Who is Obligated to Pay the Sales Tax**? The Target/seller has the obligation to pay the sales tax with the seller's final sales and use tax return filed with the California State Board of Equalization. However, the Acquirer/buyer has an obligation to withhold enough of the purchase price for the seller's sales tax liability. [California Rev. and Tax. Code §6811.]

> **PLANNING IDEA**: If under the terms of the business's purchase and sale documents the buyer is expected to pay the sales tax, the Target/seller should have the Acquirer/buyer deposit with the seller enough monies for this tax.

12.2 ***Documentary Transfer Tax***. Local jurisdictions will apply a documentary transfer tax to the transfer of real estate in the sale of the business.

12.3 ***Proposition 13 Reassessment of Real Estate***. If real estate is sold as part of an asset sale or if the selling corporation, whose stock is being sold, is comprised of real estate, then there may be a "change of ownership" and a property tax reassessment of such real estate's value.

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13. SPECIAL FEDERAL AND CALIFORNIA TAX RATES FOR THE SALE OF SMALL BUSINESS STOCK

The sale of qualified small business stock ("QSBS") can qualify for lower federal and California income tax rates.

Under §1202(a), 50 percent of a non-corporate taxpayer's gain on the sale or exchange of QSBS issued after August 10, 1993 is excluded from gross income if the taxpayer held the stock for more than five years.

However, because of the federal AMT on QSBS sales, the effective federal tax rate on a QSBS sale where there is AMT is now 14.98 percent (compared to a 15% maximum federal long-term capital gain rates).[38] See paragraph 13.3, below, for the effect of the California AMT. Accordingly, the AMT effectively eliminates the QSBS lower tax rates of §1202.

13.1 ***Rollover of Gain on QSBS Stock Sale***. Non-corporate shareholders can also rollover gain on their sale of QSBS by purchasing other QSBS within 60 days of the date of sale. In order to qualify as QSBS for rollover treatment, the QSBS must be issued

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[38] Under the AMT, 42 percent of the excluded amount under §1202 of QSBS is an item of tax preference.

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by a C corporation which is engaged in an active business. [§1045(a).]

13.2 ***Requirements to Be a QSBS***. QSBS is any stock which satisfies all of the following:

(a) stock issued by a C corporation;

(b) stock must be originally issued after August 10, 1993;

(c) the taxpayer claiming the exclusion acquires the stock at its original issuance for money or other property (not stock) or as compensation for services provided to the corporation [§1202(c)(1)(B)];

(d) when the stock is issued the corporation is a qualified small business. This means a domestic C corporation whose total "aggregate gross assets" (treating all members of the same parent-subsidiary control group as one corporation) at all times after August 10, 1993 and before the issuance of the stock and immediately after the issuance (taking into account amounts received in the stock issuance) does not exceed $50,000,000 and which has met certain reporting requirements; and

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(e) during substantially all of the taxpayer's holding period of the stock, the corporation meets the "active business test" which is that at least 80 percent of the corporation's assets must be used in the active conduct of one or more trades or businesses other than banking, insurance, or other businesses having the reputation or skill of its employees as its principal asset.

The corporation that issued the small business stock must file reports with the IRS and the corporation's shareholders.

13.3 ***California Small Business Stock Rules***. California has reduced rates on the sale of small business C corporation stock under California Rev. and Tax. Code §18152.5. Non-corporate taxpayers can exclude up to 50 percent of the stock's sales gain. The stock must be held five years. Gain which can be excluded is limited to $10,000,000 per issuer.

Many of the California tax requirements are similar to the federal rules. However, California has its own AMT, similar to the federal AMT rules. Fifty percent of gain from the sale or exchange of QSBS is a "tax preference item" that must be added back in computing the California AMT. [See California Rev. and Tax. Code §§18152.5 and 17062(e).] The California AMT rate is seven percent.

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14. INITIAL ITEMS TO DO IN A BUSINESS ACQUISITION AND SALE

14.1 ***First, Determine the Sale's Deal Points***. Analyze the financial aspects of the client's proposed deal for the business's sale.

14.2 ***What Are the First Documents That Are Done in a Business's Sale***?

(a) **Confidentiality Agreement**. A seller will desire that a confidentiality agreement be signed by the prospective buyer. A confidentiality agreement protects the seller by prohibiting the buyer from using the seller's customer lists, trade secrets, and other seller confidential information.

(b) **Letter of Intent**. Both the Buyer and Seller will want to first have a letter of intent in order to set forth their basic deal terms of the business's sale. Letters of intent normally specify that they are not legally binding (however, the buyer and seller can choose to make a letter of intent legally binding).

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15. <u>TYPES OF REPRESENTATIONS AND WARRANTIES WHICH THE TARGET/SELLER MAKES TO THE ACQUIRER/BUYER, WHETHER IN AN ASSET SALE OR IN A STOCK SALE</u>

15.1 ***<u>Agreement That the Representations and Warranties Survive the Closing</u>***. The buyer wants a clause in the purchase agreement which states that the seller's representations and warranties survive the close of the business's sale.

15.2 ***<u>The Buyer Wants the Representations to Be Joint and Several Among the Target/Selling Corporation and the Individual Shareholders</u>***. If there is a multiple number of sellers, such as multiple selling shareholders, or a selling corporation and several selling shareholders, then the buyer wants to obtain joint and several representations from the selling corporation and each selling shareholder.

15.3 ***<u>Where is the Selling Corporation Organized</u>***? A representation should state where the selling corporation is organized. The buyer should independently verify the seller's qualification to do business in all states where the selling corporation does business.

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15.4 ***Subsidiaries***. The seller should warrant that there are no other subsidiaries or affiliates of the seller, other than those stated.

15.5 ***Has Seller Obtained All Necessary Approvals for the Closing***? The seller should represent that the seller has obtained all necessary authorizations and approvals. The seller needs such approvals as special licenses, contracts, leases, consents to assignments, etc.

15.6 ***Capitalization of the Seller***. The buyer should verify the capitalization of the seller corporation and the number of the seller's shares issued. Verify if there is preferred stock or debt. Have representation of where the seller's articles of incorporation and any amendments were filed, along with seller's corporate filings.

15.7 ***Seller's Liens and Encumbrances***. Are there any encumbrances on the seller's shares or assets which are being transferred, such as secured debt, mechanics' liens, or property tax liens. The buyer will want to do UCC searches and real property title searches.

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15.8 ***The Buyer Will Want to Review All of the Seller's Financial Statements***.

(a) **True and Correct**. The buyer wants the seller to warrant that all of the seller's financial statements attached to the purchase agreement are true and correct.

(b) **No Seller Major Events**. The buyer wants the seller to warrant that there have been no major events since the seller's last financial statement, and that the seller's has conducted its business in the normal course.

(c) **Seller's Accounting Methods**. The buyer wants a seller to warrant that the seller's books and records accurately reflect the assets and have been prepared in accordance with generally accepted accounting principles.

(d) **Items on Seller's Financial Statements**. The buyer wants specific warranties regarding the seller's accounts receivable, short and long term debt, tax liabilities, etc.

15.9 ***Seller's Accounts Receivable***. Buyer may wish for the seller to warrant the amounts of any of seller's bad debt reserves. The buyer may ask the seller to warrant that the seller's accounts receivable are 100 percent collectible. The buyer may wish to

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debit the purchase price for any of the seller's accounts receivable which are not collected after a specified time period.

15.10 ***Seller's Product Warranties***. Who is to be responsible for any product warranties and product failures which occur prior to the closing date?

15.11 ***Seller's Inventory***. Should the seller warrant its inventory? Some common warranties are that the inventory is normal, that there is no obsolete inventory, and that the seller's inventory is valued at the lower of cost or market on the seller's balance sheet.

15.12 ***Seller's Plant and Equipment***. The seller's plant and equipment should only be in amounts which are required to run the seller's business.

15.13 ***Warranties as to Seller Liabilities***.

(a) **Buyer May Want Seller to Warrant That There Are No Unknown Liabilities or Contingent Liabilities**. For events or acts of the seller prior to the closing date.

(b) **Buyer May Want the Seller to Warrant That There Are No Target Lawsuits Other Than Those Specifically Disclosed**. The

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buyer may want these lawsuits to be defended at the seller's cost, and for their liabilities to be paid by the seller.

(c) **Buyer Wants the Seller to Warrant That There Are Only Certain Specified Seller Liens or Encumbrances**. The buyer wants to be responsible for only specified liens or encumbrances specifically assumed by buyer as shown on a schedule attached to the purchase agreement.

15.14 ***Seller's Compliance With Laws***. The buyer may request that the seller warrant that the seller is in compliance with all federal, state and local laws such as hazardous waste laws. Some of the laws covered by the seller's warranty are:

(a) **Licensing Laws**.

(b) **Building Codes**.

(c) **Trade Secret and Patent Statutes**.

(d) **Hazardous Waste Disposal**.

(e) **OSHA and Working Conditions**.

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15.15 ***Seller's Employment Agreements***. The buyer may want the seller to warrant that there are no employment, consulting, distribution, manufacturer, or independent contractor agreements other than those listed on a schedule. The buyer may want the seller to warrant that there are no union contracts or any oral employment agreements (other than those listed on a schedule to the purchase agreement). Who is to be responsible for the seller's employees' accrued vacation pay and accrued bonuses, such as Christmas bonuses, profit sharing plans or option agreements?

15.16 ***Buyer Will Want to Verify If There is Any Seller Litigation***.

(a) Buyer may ask that all of the seller's litigation (whether the seller is a plaintiff or defendant) be disclosed on schedules to the business's purchase agreement.

(b) The buyer and seller can have the purchase agreement specify who is responsible for any ongoing litigation and for the payment of attorneys' fees for this litigation. Buyer may want to request reserves against the purchase price paid to seller for any of the seller's litigation.

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15.17 ***Leases and Contracts of the Seller***. The buyer may request that the seller warrant that there are no defaults under any of the seller's leases or contracts.

15.18 ***Intellectual Property of the Seller***. The buyer may want the seller to warrant the condition of all patents, trademarks, trade names and trade secrets, and that the seller is conveying to the buyer good and marketable title. Also, the buyer may request that the seller warrant that there is no violation of any of the seller's trademarks or patents. The buyer may want to do a trademark search.

15.19 ***Seller's Insurance***. The buyer may want to review the seller's insurance policies. The buyer will want to see the availability of insurance for the business being purchased or whether insurance has been terminated in recent years.

15.20 ***Tax Issues of the Seller***. Who is responsible for the seller's taxes accrued before the closing date? Is there a seller short-year tax return for year of sale?

(a) **Withholding Taxes**.

(b) **State Board of Equalization and California Department of Employee Benefits Clearances**.

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(c) **Personal Property Taxes**.

(d) **Real Property Taxes**.

(e) **Parties Will Negotiate Who is Responsible For Paying the Sales and Use Taxes Caused By an Asset Sale**.

15.21 ***Review Schedules and Exhibits***. If the seller prepares the schedules and exhibits to the purchase agreement, then the buyer should review copies of these items in advance of the closing. Do these exhibits exculpate the seller from being responsible for certain seller's representations and warranties?

The seller's schedules and exhibits can include the following:

(a) **List of employment agreements and employee benefit plans**.

(b) **List of insurance policies**.

(c) **List of trademark applications, trademarks and patents**.

(d) **List of the seller's products**.

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(e) **List of the seller's contracts** (both oral and written).

(f) **List of any seller litigation**.

(g) **List of the seller's bank accounts and other depository accounts and balances**.

(h) **Personal and equipment leases**.

(i) **List and description of seller loan agreements, mortgages, deeds of trust, encumbrances and liens**.

(j) **List of the seller's largest customers**.

(k) **Accounts receivable list, including aging, customers, and when incurred**.

15.22 ***Buyer May Request That the Seller Warrant Completeness of Seller's Corporate Minutes and Stock Transfer Records***.

15.23 ***No Adverse Change to the Seller's Business***. The buyer should consider having the seller warrant that there have

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been no material adverse changes in the seller's business and that there has been no damage to the seller's business prior to the closing. This representation and warranty shifts to the seller the economic risk for an earthquake, natural disaster, or major business downturn affecting the seller prior to the closing.

16. INDEMNIFICATION OF THE BUYER BY THE SELLER AND THE SELLER'S SHAREHOLDERS

16.1 ***Form of Indemnification***. The buyer should consider being indemnified by the seller (and the seller's shareholders) regarding representations and warranties, and to be reimbursed for the buyer's attorneys' fees in the event of the seller's violation.

16.2 ***Seller May Want Time Limits of the Survival of Any Representations and Warranties***. The seller may want to limit the time of the survival of any of any seller representations and warranties, such as for a period of one or two years.

16.3 ***Seller May Want to Limit Any of Seller's Indemnifications to a Certain Dollar Amount***. The seller may want to limit the seller's indemnification to only amounts over a specified dollar amount (such as $50,000).

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16.4 ***Seller May Want an Upper Dollar Limitation on the Seller's Indemnification***. The seller may want to limit the seller's total indemnification to the amount of the purchase price which the seller received, in order that seller is in no worse a financial position than if the seller never sold the business.

17. SELLER AND SELLER'S SHAREHOLDERS COVENANT AGAINST COMPETING WITH THE BUSINESS WHICH THE BUYER PURCHASES

17.1 ***Seller, Shareholder and Key Employees Agree Not to Compete***. The buyer will want the seller to not compete with buyer in the purchased business for a specified number of years and for a specified geographic area.

17.2 ***Seller's Trade Secrets***. The buyer may want the seller (and seller's shareholders) to covenant to not disclose any trade secrets and to use the seller's best efforts to prevent other persons from disclosing trade secrets.

17.3 ***Seller's Non-interference With Employees***. The buyer may want the seller to covenant to not interfere with the seller's former business or former employees.

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17.4 ***Parties May Desire to Preserve Confidentiality of Transaction***. Both the buyer and the seller may desire to covenant with each other to preserve the confidentiality of the purchase price and terms of the business's sale.

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