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TAX STRATEGIES FOR BUYING AND SELLING BUSINESSES

by

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TAX STRATEGIES FOR BUYING AND SELLING BUSINESSES

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1. INTRODUCTION

The 2003 Tax Act's[1] revised tax rates reduces the tax costs of selling a business. 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 maximizes tax benefits.

1.1 ***Double Level of Taxation on C Corporations***. 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 net sales proceeds are distributed to the shareholders in a corporate liquidation.

(a) **Combined Federal and California Tax Rate on C Corporations**. Even after the 2003 Tax Act's tax reductions, this double taxation of the purchase price paid to a C corporation in an asset sale produces a 53.25% tax rate after taking into account the

[1] Known as The Jobs and Growth Tax Relief Reconciliation Act of 2003.

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effect of California tax.[2] This combined tax rate will increase after the federal capital gain rate increases to 20% in 2009. This current combined 53.25% rate on an assets' sale gain should be contrasted with a stock sale where the one level of tax on the gain produces a low combined 21.04% federal and California capital gain rate.

> **Planning Idea**:
>
> Selling shareholders can change their residency to outside of California prior to selling their business in order to avoid the California individual income tax. For this plan to work, the business should not have a California business situs.[3]

(b) **Effect of Federal Alternative Minimum Tax**. These tax rates assume that there is no federal individual alternative minimum tax ("AMT") which is at a maximum 28% federal 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 AMT where they have a large amount of taxable gain from the sale of their business.[4]

(c) **New Production Activities Income Tax Deduction Commencing in 2005**. The recently enacted "American Jobs Creation Act of 2004" created a new deduction for qualified production

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[2] 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% 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% corporate federal rate) for corporations that have income that does not exceed $10,000,000.

[3] 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.

[4] Under the 2004 Working Families Tax Act, for tax years beginning in 2004 to 2005, the AMT exemption amount remains at $40,250 for unmarried persons and $50,000 for married persons filing jointly.

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activities income which effectively reduces the tax rate for C corporations, partnership, LLCs, and even proprietorships. 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% of the W-2 wages paid by the taxpayer for the tax year. The result of new Code §199 is that the effective tax rate for C corporations is reduced three percent when the full phase in of the §199 deduction occurs in 2010.

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 is allocated to immediately deductible items or those that can be amortized over short time periods, the buyer benefits by these increased tax deductions. On the other hand, the seller desires to reduce or avoid any immediate tax liability as a result of the business's sale. It is important how the business's purchase is structured (stock sale or asset sale), how the allocation of the purchase price is made (how much of the price is allocated to a specific asset), and whether the transaction is structured as a taxable sale or is a tax-free reorganization.

1.3 ***<u>General Tax Themes of Buyer and Selling a Business</u>***. Although each business's acquisition has its own unique issues, some general tax themes are discussed below.

(a) **<u>Tax Positions of Buyer and Seller</u>**. In the absence of non-tax reasons for selling shares (such as the inability to transfer a license or franchise), the buyer of a business owned in corporate form generally prefers an asset acquisition in order to obtain a stepped-up tax basis in the acquired assets and to reduce the buyer's exposure to pre-closing liabilities. However, this results in the selling shareholders paying a much higher effective tax rate (both a corporate level tax and a shareholder level tax). Therefore, 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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(b) **If the Selling C Corporation Has Operating Losses, Then Can Use These Tax Losses to Avoid Gain on an Assets' Sale**. If the selling 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.

2. SALE OF THE SELLING CORPORATION'S SHARES

This is the simplest technique by which a seller (or shareholders of the "Target" corporation) can avoid the "double level" of taxation on the sale of its business. The selling shareholders assign all of their shares to a 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 gain is taxed to the selling shareholders at capital gain rates which will be a 15% maximum federal rate for individuals in the highest tax bracket. [§1(h).]

2.1 ***Tax Basis in Shares Sold***. Generally the tax basis of stock in a closely-held corporation is low. In community property states like California, shareholders receive a §1014 fair market value basis for their entire share ownership upon the death of the first spouse.[5] Such a stepped-up basis could result in no gain to the selling shareholder. If the selling corporation owes debt to a shareholder upon sale of the business, this debt could be contributed to the corporation for additional basis in stock. Alternatively, the debt could be paid back to the shareholder, or the corporation could redeem the shares immediately prior to the sale in exchange for the debt.

2.2 ***Non-Sold Assets Such as Cash, Accounts Receivable and Automobiles***. Many times when a business is sold the selling shareholders will desire to retain certain assets such as cash, accounts receivable, or shareholder automobiles. In a stock sale, one technique for accomplishing this goal is to have a partial stock redemption in exchange for these "special" assets immediately prior to the sale. 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

[5] This step up in basis will be repealed for one year in 2010 under the 2003 Tax Act. However, it is likely Congress will be amending these tax rules.

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

> **<u>Planning Idea</u>**:
>
> Consider reducing such "special assets gain" by not redeeming low basis assets or by revaluing these special redeemed assets to a lower fair market value.

2.3 ***<u>Post-Closing Adjustments</u>***. In a business sale it is common for there to be 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 the gain for post closing adjustments to be capital gain these adjustments should be specified in the stock purchase agreement as relating to the sale of stock.

> **<u>Planning Idea</u>**:
>
> **<u>How can the selling/Target shareholders have the transaction structured as a stock sale?</u>** If you represent the seller of a business and you desire 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 the issue until later. Most buyers of shares will request that the stock acquisition documents include shareholder representations and warranties regarding liabilities and pre-closing debts, etc.

2.4 ***<u>Tax Result to a Corporation Buying Shares of the Target Corporation</u>***.

(a) **<u>General Rule of No Gain to Buying Corporation and No Step-Up in Target's Assets' Basis</u>.** If the buyer is a corporation ("Acquiring corporation") purchasing all of the shares of a Target corporation, and such Acquiring corporation liquidates the selling/Target corporation, then pursuant to §332 the Acquiring corporation recognizes <u>no</u> gain or loss on the liquidation of the new subsidiary/Target corporation. [§332(a).] The selling/Target corporation (which becomes a subsidiary of the Acquiring

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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 their then tax basis (and not a stepped-up basis). [§334(b)(1).] The Acquiring corporation, however, may not be satisfied with this lower tax basis in the assets, since a low asset tax bases results in the Acquiring corporation receiving less depreciation deductions, recognizing more gain upon the sale of assets (including future inventory sales), all of which results in higher future taxes for the Acquiring corporation.

(b) **Section 338 Election**. To increase the basis in the Target corporation's assets, the Acquiring corporation can make a §338 election. If a stock sale of the Target corporation is made to a buying corporation, the Target corporation becomes a subsidiary corporation of the Acquiring corporation. Under §338, the Acquiring corporation can elect to treat its new Target subsidiary: (i) as having sold all of its assets to the Acquiring corporation in a single transaction for their fair 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 result 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 basis equal to their fair market value, which should equal the purchase price of the Target corporation's stock. The Target corporation 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 the Target corporation is required to recognize gain on the deemed 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 §338 election will be advantageous, for example if the Target corporation has net operating losses to offset the recognized gain.

(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% of the Target selling corporation's stock within a 12-month period [§338(d)(3)], and (iii) must make the §338 election by filing Form 8023.

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(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 Selling/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 simply 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) **Can Have the §338 Tax Apply to the Target/Seller By Making a §338(h) Election**. An alternative election available under §338 is the §338(h)(10) election. The "(h)(10)" election is available if the selling/Target corporation is a member of an affiliated group (regardless of whether consolidated returns are filed). [Reg. §1.338(h)(10)-1(e)(1).] Under §338(h)(10) the selling/Target corporation recognizes gain as if it sold its assets to the Acquiring corporation. The result of an (h)(10) election is that the selling/Target corporation can dispose of its assets to the buying corporation with only one tax at the Target corporation's level. The selling/Target corporation's consolidated group bears the tax of the §338 deemed asset sale. No gain or loss is recognized when the Target corporate shareholder sells the Target corporation's stock to the acquiring corporation. The acquiring corporation thus acquires the Target corporation with a stepped-up basis in the Target corporation's assets. An (h)(10) election should be considered by a Target/selling affiliated group, where the subsidiary Target's assets have less inherent gain than the parent's basis in the Target's stock, or where the selling consolidated group has current operating losses or NOL carryovers. The (h)(10) election <u>cannot</u> be used for sales by individual shareholders or a non-controlling group of corporate shareholders. The (h)(10) election, like the conventional §338 election, produces a stepped-up basis in the Target's assets.

3. SALE OF THE SELLING 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

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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, goodwill and certain intangible assets requires that the buyer amortize these assets over 15 years 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 structure also 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.

3.1 ***Allocation of Purchase Price Under §1060***. 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. Congress felt that by mandating the use of the "residual method," the valuation issues for goodwill and going concern value would be eliminated, and the "premium" paid in excess of the total fair market value of the purchased assets would be treated as goodwill or going concern value. 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) **Stock Sale and §1060**. Section 1060 information requirements not only applies to asset acquisitions, but also applies where a 10% or more owner of an entity transfers an interest in such entity and in connection with such transfer, such person or related person enters into an employment agreement,

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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.

3.2 ***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:

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, with any excess being allocated to the Class II, III, IV, V, VI and VII 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.

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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).

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.

3.3 ***Is an Allocation Agreement Binding?*** Section 1060(a) specifies that a written agreement made by buyer and seller as to the allocation or fair market value of the sold assets (within the above class framework) 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. [Committee Reports to the Revenue Reconciliation Act of 1990.]

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

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Asset	FMV	Class
Savings accounts and cash	$ 300,000	I
General Motors 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.

3.5 ***Subsequent Adjustments to Purchase Price***. In most sales of businesses, there will be some form of 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 to the buyer. The Regulations under §1060 specify that an increase in the purchase price is allocated among all of the transferred assets.

3.6 ***Reporting Requirements of §1060***. The Target/selling corporation and buying/acquiring corporation in an applicable asset acquisition are required to file asset acquisition statements on IRS Form 8594 with their tax returns for the taxable year that includes the purchase date. The purpose of requiring this form is to promote consistent treatment by both the buyer and Target/seller.

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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 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 or other similar arrangement with the Target/seller.

(b) **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. [Reg. §1.1060-1T(e)(1)(ii)(B).]

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

3.7 ***Allocation to Tangible Personal Property***. The buying entity will allocate to tangible personal property as a Class V asset under §1060. The buyer will then amortize the purchase price of such personal property over the shorter recovery periods under §168(c). 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. Allocations of the purchase price to personal property may be subject to state sales and use tax.

3.8 ***Allocation to Real Estate***. Generally, the buyer/acquirer will wish to avoid allocations to real estate since the recovery period for improvements is much longer than personal property (39 years for non-residential real estate under §168(c)) and amounts allocated to land cannot be depreciated. The Target/seller may prefer an allocation to real estate to tax the seller (and its shareholders) at lower capital gains rates (except for the recapture portion which is taxed at a 25% rate). Allocations to real estate may require the payment of a local documentary transfer tax when the deed is recorded.

3.9 ***Allocation to Inventory***. A buyer will try to allocate as much of the purchase price as possible to inventory in order to reduce ordinary income when the inventory is sold. The Target/seller, to the extent of its tax basis in the inventory, will recognize no gain.

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4. EMPLOYMENT AGREEMENTS AND CONSULTING AGREEMENTS

Buyers of a corporate-owned business, in order to immediately expense payments and to avoid §197 (15-year amortization) and additional corporate level tax, may try to characterize a portion of the purchase price as payment for an employment agreement or consulting agreement (to get an immediate §162 deduction). The result of such a characterization is that payments by the buyer are deductible as a §162 expense when paid for a bona fide employment or consulting agreement. Additionally, by using employment agreements or consulting agreements, buyers may try to avoid the §1060 asset class allocation rules.

4.1 ***Tax Effect on Buyer and Target/Seller***. Payments under employment or consulting agreements are deductible by the buyer as §162 expenses in the year of payment and are includable by the recipient (i.e., the selling shareholder) in the year of receipt. The recipient of these payments would be taxed at ordinary income rates (federal tax plus California state tax) instead of the lower federal capital gain rates.

> **Planning Idea**:
>
> **Use Qualified Plans to Defer the Seller's Income Taxes**. Selling shareholders can set up qualified deferred compensation plans to defer the tax on an employment agreement's payments. Earnings, dividends and sales proceeds will be tax exempt to the qualified plan.

4.2 ***Reporting to IRS***. In a business acquisition, must be reported on Form 8594, including the maximum amount of consideration paid thereunder.

4.3 ***The Compensation Paid to the Selling Shareholders Must Be Reasonable***. To prove that the compensation paid under an employment or consulting agreement is reasonable, the parties should recite in their employment and consulting agreement documents and have evidence of the following:

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

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(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; and

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

Other factors validating an employment or consulting agreements are that the agreement is negotiated separately from the main asset purchase agreement, and that the shareholder/employee is required to spend a specified number of hours per week in the business.

4.4 ***Tax and Business Points Important to the Target Shareholder/Employee***. The Target shareholder/employee will have to report amounts received under the employment agreement as ordinary income. 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.[6] The selling shareholder/employee will want the consideration under the employment/consulting agreement to be guaranteed, even if the employee is disabled or dies, or his services are terminated for any other reason. In other words, the employee/seller may expect to receive consideration whether or not the employee is providing services. The agreement must be structured so that the payments are legally enforceable. Should the employment agreement be secured by a UCC-1 or letter of credit? Should there be personal guarantees for an employment agreement?

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

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[6] Salaries will, however, be subject to the FICA tax to both the paying (employer/buyer) and recipient (employee/selling shareholder) to the extent in excess of the maximum wage base. The tax rate is 6.2% to both the employer and employee on the first $87,900 of wages in 2004. The Medicare hospital insurance portion of the FICA tax results in a tax rate of 1.45% on both the employer and employee for all wage payments with no minimum base.

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5. HOW TO TREAT SECTION 197 INTANGIBLE ASSETS IN THE SALE OF A BUSINESS

Section 197 requires that a ratable amortization over a 15-year period of intangibles such as goodwill, customer lists, subscription lists, patents, copyrights, know-how, covenants not to compete and other intangible assets. 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.

5.1 ***Covenants Not to Compete and Goodwill***.

(a) **Tax Treatment**. The shareholder of a Target/selling corporation receiving consideration for a covenant not to compete will report the consideration as ordinary income in year of receipt. The buying corporation will deduct or amortize the payments for the covenant not to compete over 15 years under §197 (even though the covenant may last for only a short period of time, such as five years). [§197(d)(1)(E).]

(b) **Covenant Not to Compete Versus Goodwill**. The 15-year amortization period applies to a buyer's payments for both covenants not to compete and for goodwill. For a pass through entity, with the reduced long-term capital gain rates which will apply to the seller of the goodwill, there is an incentive to allocate more of the purchase price to goodwill (which is taxed to the recipient pass through entity's owners at the lower capital gains rates), rather than allocate to a covenant not to compete (which is taxed to the recipient at the higher ordinary income tax rates).

5.2 ***Information Based Assets***. These are §197 intangibles such as business books and records, operating systems and any other information based list or other information of current or prospective customers. Examples would be technical manuals, training manuals or programs, data files, and accounting or inventory control systems, as well as the cost of acquiring a customer list, subscription list, insurance expirations, patient or client files, or lists of media advisors. [§197(d).] As §197 assets, the purchase price of these intangibles must be amortized over 15 years.

5.3 ***Leases***. Very often the Target/seller will have a favorable real property lease which is being assigned to the buyer

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as part of the sold assets. If the lease were entered into many years previously, the lease may have rents below current rent value. The excess value between the current rent value and the rent value under the lease can be "sold" as an asset. This value being purchased by the buying corporation is amortized by the buying corporation over the remaining term of the lease. As to a lessor's favorable lease position (i.e., lessor is receiving above market rents), this sold asset must be amortized over the life of the real estate being sold. For example, if there are leases in favor of a landlord on a shopping center, the portion of the acquisition price attributable to the favorable retail store lease must be added as part of the basis of the shopping center and amortized over 39 years.[7]

5.4 ***Patents***. Patents are not amortized over 15 years if sold separate from the sale of a business. [§197(e)(4)(c).] Patents may present an income stream in the form of royalties over a specified number of years (or one lump sum payment) or simply may represent technology (such as a trade secret) being purchased by the buying corporation. If the patent is licensed to a third party for a royalty stream, then the value of the asset can be determined by reference to these royalties. If the purchase price of a patent (or a copyright) 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. Otherwise, the buyer must depreciate the basis in the purchased patent ratably over the patent's remaining life. [Reg. §1.167(a)-14(c)(4).]

5.5 ***Allocation to 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, clients can still apply §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

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

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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 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 is a §197 intangible asset and must be amortized over 15 years. However, the payments based upon gross sales are not §197 assets and can be deducted as paid because the payments are serial contingent payments as defined in §1253(d). [Reg. §1.197-2(b).]

Example: McClain, Inc. purchased 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, does constitute a §197 intangible asset and must be amortized over the 15-year period. [Reg. §1.197-2(b).]

5.6 ***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 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 amount can be currently deductible so long as it is the type of software that is readily available for purchase by the general public.

Example: Assume that Bill in selling his auto parts manufacturing company to Horton, Inc. receives from Horton, Inc. license payments each year. Provided that these license payments are reasonable for the use of the license trade secrets or patent materials, they 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).]

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5.7 ***Specific Items Which Are Not §197 Intangibles***. The regulations explain §197(e) as to what is not a 197 intangible asset. Section 197 intangible assets are not:

(a) Interests in a corporation, partnership, trust or an estate. Therefore, costs of acquiring stock, partnership interests or interests in a trust or estate cannot be amortized. [Reg. §1.197-2(c)(3).]

(b) Interests in land, life estates, remainder interests, timber rights, zoning variances and similar rights such as farm allotments cannot be amortized as a §197 asset. However, cable television franchises are not considered an interest in land and can in certain cases be a §197 amortizable asset. [Reg. §1.197-2(c)(3).]

5.8 ***How to Calculate the 15-Year Amortization***. The amortization deduction is computed by amortizing the §197 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 amounts added to the basis of the intangible asset during the 15-year period, then these amounts are amortized ratably over the remainder of the 15-year period. Where amounts are paid after the expiration of the 15-year period, such amounts are immediately deductible.

6. AVOID THE DOUBLE LEVEL OF TAXATION TO A C CORPORATION BY TREATING PART OF THE PURCHASE PRICE AS A PAYMENT FOR ASSETS OWNED BY THE SHAREHOLDERS

Avoid the C corporation level tax by paying the selling business's shareholders directly a license fee for shareholder owned trademarks, trade names, or franchises. License fees are taxed to the receiving selling shareholders at ordinary income rates (currently a maximum 35% federal), 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). Shareholders owning the business' real estate can either sell that real estate to the buying company (receiving capital gain treatment with the exception of recapture income) or the shareholders can rent the real estate

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to the buying entity (where the received rents will be taxes to the shareholders at ordinary income rates).

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

Owning the business in a limited liability company[8] or S corporation avoids the double level of taxation.

7.1 ***Spinning Off Part of the C Corporation's Business to a Pass-through Entity***. If the business is not currently owned in a pass-through entity, then prior to the business's sale clients can consider "spinning off" parts of the C corporation's business to either an S corporation or a limited liability company to avoid the double level of taxation. For example, if the client is developing a new manufacturing division or a new product line, the client can form an LLC or S 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.[9] Prudent tax planning dictates that any spin off occur well in advance of the business's sale.

7.2 ***Have the Existing C Corporation Transfer Its Assets to a Limited Liability Company or a Limited Partnership, But Maintain the Existence of the C Corporation***. The existing C corporation could transfer all of its assets "downstream" to a limited liability company or 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 limited partnership or membership interests). It also allows in the case of an S election to minimize the built-in gain tax of §1374 where the C corporation elects S corporation status, since the limited partnership

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[8] California imposes an annual tax of $800 as a franchise tax on limited liability companies, plus an annual 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 Rev. and Tax. Code.

[9] See District Court case of McCabe Packing Co., 71 AFTR2d 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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interests (or LLC membership interests) can be discounted for valuation purposes. Some of the income of the C corporation can also be shifted to lower tax bracket family members.

7.3 ***Convert C Corporation to an 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 asset sale will not produce a federal tax at the corporate level under §1374. An S corporation will still have the 1.5% California tax on its earnings, including gain on an asset sale.[10] If a C corporation is converted to S status, then there is potential built-in gains tax under §1374, loss of net operating loss carry-overs, and the inventory LIFO recapture tax.

7.4 ***Section 1374 Built-in Gains Tax Where a C Corporation is Converted to an S Corporation***. Section 1374(a) imposes a corporate level tax at the highest §11 rate (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).]

Generally, the tax on net recognized built-in gain 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).] The only exception is where a corporation which was always an S corporation acquires assets from a C corporation in a tax-free transaction.

The "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.

> **Planning Idea**: Obtain an asset appraisal upon conversion of a C corporation to an S corporation to evidence fair market value of assets on date of S election.

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

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8. SECTION 453 INSTALLMENT SALES

Shareholders instead of receiving cash for the sale of their business (which would be taxed in the year of receipt) may instead spread their sale's gain over several years by receiving back an installment promissory note.[11] A shareholder may receive back an installment obligation for a corporation's asset sale in a 12-month complete corporate liquidation, and not have the note's gain accelerated except for the California corporate tax. [§453(h)(1), and §24672 of Rev. and Tax. Code.][12] S corporations are subject to the 1-1/2% California tax on the income from an installment note in the year of dissolution or soon as monies are paid on the note.[13] Installment notes can be secured by qualifying standby letters of credit or by the sold business's assets.[14]

[11] An installment note is permitted to defer gain recognition for either a non-publicly held stock sale or an asset sale.

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

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

[14] 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, But the Shareholders Still Wants to Defer Their 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.[15] It is preferable to do this first sale well in advance of the second sale. This third-party entity then sells the shareholders' stock to the buying corporation for all cash, recognizing no capital gains since the third-party entity's tax basis in the sold stock equals the amount of the promissory note by which the stock was purchased from the selling shareholders. The selling shareholders then are able to defer their stocks' gain by the installment note over several years, rather than recognizing all of their gain in the first year.

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.

8.2 ***Asset Sale***.

(a) **Installment Sales Rules are Applied on Asset-By-Asset Basis**. If there is an installment sale of assets, §453 is applied on an asset-by-asset basis, not as to an aggregate sale of the business. [Rev. Rul. 68-13, 1968-1 C.B. 195.] For example, §453 does not apply to sale of: assets on which the selling corporation has a loss [§453(a)]; recapture income [§453(i)][16]; publicly traded stock [§453(k)]; or inventory. [§453(b)(2)(B).]

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[15] Under §453(e), if there is a stock sale to a related party by an installment note, and the related party sells that stock within two years after the first sale, then the amount received on the second sale is treated as a payment made on the note.

[16] 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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Even if a sale is eligible for installment sales treatment, the selling corporation may elect out of §453 treatment. [§453(d).]

(b) **Seller Pays Interest on Amount of Installment Note Greater Than $5,000,000**. A disadvantage of §453 installment notes 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 on the deferred tax liability. [§453A(a).] If the §453A $5,000,000 threshold applies, then the seller must be sure to receive enough monies to enable the seller to make the tax interest payments to the IRS.

Planning Idea:

Allocate the Installment §453 Note to Only Qualifying Assets. The Purchase Price must be allocated between all of the assets under §1060. Prior to the enactment of §1060, the buyer and seller could allocate cash and deferred payments in a non-pro rata manner [Rev. Rul. 76-110, 1976-1 C.B. 126]. Cash could be allocated to assets not eligible for installment sales treatment (such as assets with recapture or publicly-held stock), and the §453 installment note could be allocated to the assets that were eligible. [Rev. Rul. 68-13, 1968-1 C.B. 195.] There is no authority to deny this continued tax planning by allocating the §453 note to only certain qualifying assets.

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

A charitable remainder trust ("CRT") allows the selling shareholders to contribute some or all of their business's stock to the CRT, receive a charitable income tax deduction and then have the CRT 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.[17]

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[17] 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 sales proceeds are invested in tax-exempt bonds, the annual CRT payments to the client/beneficiary will be taxed at capital gains rates.

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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.[18]

10. USE OF 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 back stock in the buying corporation in exchange for the transfer of the Target's shares or assets, generally there will be no recognition of gain under the tax-free reorganization rules of §§354-368. The reason that no gain is recognized is that the new property received (stock in the buying corporation) is substantially a continuation of the "old investment" (the stock in the Target/selling corporation). In a reorganization, the selling shareholder's taxable gain is deferred by having a substituted tax basis in the received buyer's stock which equals the basis of the selling shareholder's shares, with certain adjustments.[19] 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. The various facets of the corporate tax-free reorganization are beyond the scope of this outline.

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

(a) **Effect of Tax-free Reorganization on Seller**. The Target/seller shareholders are able to defer the tax on the seller's stock until the stock which the seller receives in the buyer/acquiring corporation is sold. The tax can be completely avoided if the Target/selling shareholders holds the buying/acquirer's stock until the death of the selling shareholder or their spouse. Gain from the seller's receipt of cash or other

[18] 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 to the client, rather than to the CRT or charity. See Rev. Rul. 78-197, 1978-1 CB 83; and ***Ferguson***, 83 AFTR2d 99-1775 (CA 9, 1999).

[19] See §358. The received stock's basis is the same as the 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 shareholder.

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"boot" in the exchange, whether treated as qualified dividend income or capital gains will still be taxed at the maximum 15% rate.[20]

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

Planning Idea:

How Selling Shareholders Can Diversify Their Stock Holdings After the Tax-free Reorganization. One drawback of a selling shareholder receiving a large number of shares in the 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 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***. By way of summation, the various types of tax-free reorganizations are listed below.

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

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[20] See §356. The 2003 Tax Act added §1(h)(11) which taxes qualified dividend income at a maximum 15% rate. Certain forms of reorganizations limit or prohibit the amount of non-stock (or "boot") consideration which the seller can receive.

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(b) **"B" Reorganization**. Acquisition by the 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.

(c) **"C" Reorganization**. Acquisition by the buying corporation, in exchange for the buying corporation's shares, of substantially all of the assets of the Target/selling corporation.

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

10.3 ***Sellers Receive Shares of the Buying Corporation***. Selling shareholders may prefer not to receive shares of the buying corporation because of the risk that these shares could decline in value. However, if there is a blue chip buyer then the seller may feel more comfortable.

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

In addition to the California state income or franchise taxes at the individual and corporate level. There are special types of California taxes such as sales and use taxes, documentary transfer taxes for real estate and special tax rates for sales of stock.

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

(a) **Occasional Sales Exemption**. 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. [Rev. and Tax. Code §6006.5(a) and Cal. Reg. §1595(a).] If more than two sales of tangible personal property is made during any 12-month period, then the sales tax applies (and the "occasional" sales exemption does not apply). Thus, to qualify as an "occasional

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sale," the business asset sale should be an "isolated transaction."[21]

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

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

Planning Idea:

If under the terms of the sales documents the buyer is expected to pay the sales tax, the seller should have the buyer deposit with the seller enough monies for this tax.

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

[21] 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. [Cal. 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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11.3 ***<u>Proposition 13 Reassessment of Real Estate</u>***. 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 will be a "change of ownership" and a property tax reassessment of such real estate's value.

12. <u>SPECIAL FEDERAL TAX RULES FOR PLANNING THE SALE OF A BUSINESS</u>

12.1 ***<u>Rollover of Gain</u>***. Non-corporate shareholders can rollover gain on their sale of qualified small business stock ("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 held for at least six months and be issued by a C corporation which is engaged in an active business. [§1045(a).]

12.2 ***<u>Requirements to Be QSBS</u>***. QSBS is any stock in a <u>C</u> corporation which is originally issued after August 10, 1993 if:

(a) 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 <u>after August 10, 1993</u> and <u>before the issuance of the stock and immediately after the issuance</u> (taking into account amounts received in the stock issuance) does not exceed $50,000,000 and which has met certain reporting requirements; and

(b) 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)]; and

(c) 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% 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. <u>INITIAL ITEMS TO DO IN A BUSINESS ACQUISITION</u>

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13.1 ***Determine the Deal Points***. Analyze the financial aspects of the proposed deal for the business's sale.

13.2 ***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 prevents the buyer from using the seller's customer lists, trade secrets, and other 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 can specify that they are (or are not) legally binding.

14. TYPES OF REPRESENTATIONS AND WARRANTIES WHICH THE SELLER MAKES TO THE BUYER, WHETHER IN AN ASSET SALE OR IN A STOCK SALE

14.1 ***Agreement that the Representations and Warranties Survive the Closing***. The buyer always wants a clause in the purchase agreement which states that the seller's representations and warranties survive the closing of the business's sale.

14.2 ***The Buyer Wants the Representations to Be Joint and Several Among the Target/Selling Corporation and the Individual Shareholders***. If there is a multiple number of sellers, such as multiple selling shareholders, or a selling corporation and many selling shareholders (in an asset sale), then the buyer wants to obtain joint and several representations from the selling corporation and each selling shareholder.

14.3 ***Where is the Selling Corporation Organized***? 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.

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

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14.5 ***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.

14.6 ***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.

14.7 ***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.

14.8 ***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 a 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.

14.9 ***Seller's Accounts Receivable***. The seller should warrant as to any bad debt reserves of the seller. The buyer may ask the seller to warrant that the seller's accounts receivable are 100% collectible. The buyer may wish to debit the purchase price for

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any of the seller's accounts receivable which are over 120 days old.

14.10 ***Seller's Product Warranties***. The seller should be responsible for any product warranties and product failures which occur prior to the closing date.

14.11 ***Seller's Inventory***. The seller should warrant that its 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.

14.12 ***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.

14.13 ***Undisclosed Seller Liabilities***.

(a) **Buyer Wants 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 Wants the Seller to Warrant That There Are No Target Lawsuits Other than Those Specifically Disclosed**. Buyer will 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 No Target Liens or Encumbrances**. Buyer should only be responsible for those liens or encumbrances specifically assumed by buyer on a schedule attached to the purchase agreement.

14.14 ***Seller's Compliance With Laws***. The buyer will request that the seller warrant that the seller is in compliance with all federal, state and local laws such as hazardous waste. Additionally, the buyer will want the seller to indemnify buyer regarding removal of hazardous materials. Some of the laws covered by the seller's warranty are:

(a) **Licensing Laws**.

(b) **Building Codes**.

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

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(d) **Hazardous Waste Disposal**.

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

14.15 ***Seller's Employment Agreements***. The buyer will want the seller to warrant that there are no employment, consulting, distribution, manufacturer, or independent contractor agreements other than those supplied to the buyer. The seller should also 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 accrued vacation pay and accrued bonuses, such as Christmas bonuses? Other seller bonuses, profit sharing plans or option agreements?

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

(a) All of the seller's litigation (whether the seller is a plaintiff or defendant) should be disclosed on schedules to the purchase agreement.

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

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

14.18 ***Intellectual Property of the Seller***. The buyer will 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 seller should warrant that there is no violation of any of the seller's trademarks or patents. Importantly, the buyer will want to do a trademark search.

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

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14.20 ***Tax Issues of the Seller***. The seller's taxes accruing before closing date should be the responsibility of the seller. Is there a seller short-year return for year of sale?

(a) **Withholding Taxes**.

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

(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**.

14.21 ***Buyer Will Want to Review and Verify All Schedules and Exhibits***. If the seller prepares the schedules and exhibits to a purchase agreement, then the buyer will want to review copies of these items in advance of the closing. The buyer will want to verify that the exhibits do not exculpate the seller from being responsible for the seller's representations and warranties. The seller's schedules and exhibits would include the following:

(a) **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**.

(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**.

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(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**.

14.22 ***Seller Should Warrant Completeness of Seller's Corporate Minutes and Stock Transfer Records***.

14.23 ***No Adverse Seller Business Change***. The buyer will want the Seller to warrant that there have been no material adverse changes in the business and that there has been no damage to Seller's business prior to the closing. Shifts to the Seller the economic risk for an earthquake, natural disaster, or major business downturn affecting the Seller prior to the closing.

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

15.1 ***Form of Indemnification***. The buyer will want to be indemnified by the seller (and the seller's shareholders) regarding representations and warranties and reimbursement of buyer's attorneys' fees in the event of a violation.

15.2 ***Seller Wants Time Limits of Survival of Representations and Warranties***. The seller wants to limit the time of the survival of any representations and warranties, such as to two years.

15.3 ***Seller Wants to Limit Any Indemnification to a Certain Amount***. The seller will want to limit the seller's indemnification to only amounts over a specified dollar amount, such as $50,000.

15.4 ***Seller Wants an Upper Dollar Limitation on the Seller's Indemnification***. The seller wants to limit the seller's total indemnification to the amount of the purchase price received, in order that seller is in no worse condition than if the seller never sold the business.

16. SELLER AND SELLER'S SHAREHOLDERS COVENANT AGAINST COMPETING

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16.1 ***Seller, Shareholders and Key Employees***. The buyer will want the seller to not compete with buyer for a specified number of years and for a specified geographic area. Buyer wants to structure covenant not to compete to be enforceable.

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

16.3 ***Seller's Non-interference with Employees***. The buyer wants seller to not interfere with the seller's former business or employees.

16.4 ***Parties May Desire to Preserve Confidentiality of Transaction***. Both the buyer and the seller may desire to preserve the confidentiality of the terms and purchase price of the business sale.

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