

STOCK VS. ASSET SALE: STRUCTURING THE DEAL

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A. Non-Tax Issues in the Deal Structure: Stock vs. Asset Sale

- Purchasing all or less than all the assets of the selling entity
- Limiting assumed liabilities
- Assignment of critical contracts
- Transfer of licenses

B. Non-Tax Issues - Stock Sale

- The shareholders of the corporation are the sellers
- All assets are included
- All liabilities are included (known and unknown, contingent or otherwise)
- Due diligence, representations and warranties, and indemnification protections are critical
- Generally no issues with assignment of critical contracts (other than “change of control” issues)
- Generally no issues with employee stock options (other than “change of control” issues)
- No ability to choose new accounting methods

C. Non-Tax Issues-Asset Sale

- The corporation is the seller
- Generally involves the sale by the corporation of some or all of its assets and then the liquidation of the corporation with distributions to the shareholders
- Ability to sell less than all the assets
- Ability to limit the assumed liabilities
- Certain liabilities may follow the assets even if not expressly assumed
 - tort liabilities
 - tax liabilities
 - environmental liabilities
- Third party consents for assignment of critical contracts are an issue
- Stock options for employees are an issue
- Ability to choose new accounting methods

D. Tax Issues in a Stock Sale Involving Cash and/or Promissory Notes

Corporation Perspective

- No tax implications on the corporation itself
- Corporation's basis in its assets remains the same

D. Tax Issues in a Stock Sale Involving Cash and/or Promissory Notes (cont'd)

Shareholder Perspective

- Taxable income for the selling shareholders of the corporation
- Tax based upon the difference between the price paid for the stock and the basis in the stock
- Basis equals capital contributed to the corporation plus profit allocated to the shareholder (in a pass-through entity) less distributions to the shareholder less losses allocated to the shareholder (in a pass-through entity)
- Tax is usually based upon capital gains rate of 15% (assuming stock is held for 12 months)

D. Tax Issues in a Stock Sale Involving Cash and/or Promissory Notes (cont'd)

Shareholder Perspective (cont'd)

- If the purchase price is paid through the issuance of a promissory note, the shareholders can generally report the gain on an installment basis so long as:
 - seller is a cash based taxpayer
 - promissory note is not payable on demand
 - stock sold is not publicly traded
- In an installment sale, selling shareholders report proportionate amount of gain as they collect portions of the purchase price

D. Tax Issues in a Stock Sale Involving Cash and/or Promissory Notes (cont'd)

Purchaser Perspective

- Purchaser's basis in the stock purchased is the price paid plus acquisition costs

D. Tax Issues in a Stock Sale Involving Cash and/or Promissory Notes (cont'd)

Example

Facts: Shareholder bought 100 shares (constituting 100%) of target corporation for a total investment of \$1,000. Target corporation is sold two years later through a stock sale for \$20,000. Assume at the time of sale that shareholder's basis equals the total investment made in the shares of \$1,000.

Result: Target corporation does not realize any gain on the sale. Shareholder realizes a \$19,000 gain equal to the sale price of his stock (\$20,000) less his basis in the stock (\$1,000). Assuming the sale qualifies as a long term capital gain, shareholder pays capital gain taxes on \$19,000 at the rate of 15%. Purchaser's basis in the stock of the target corporation is \$20,000.

E. Tax Free Exchange in a Stock Sale

- Acquiring all the stock of a corporation in exchange for the purchaser's stock is generally tax free to the selling shareholders under Section 368 of the Internal Revenue Code
- Taxable to the extent any boot (cash or other property) is received by the selling shareholders
- Selling shareholders' basis in the purchaser's stock equals their basis in the stock sold

F. Tax Issues in an Asset Sale Involving a C Corporation

Corporation Perspective

- Corporation pays tax on any gain realized through the sale of its assets
- Tax based upon the difference between the sale price of the assets and the corporation's basis in the assets
- Corporate capital gain tax rates are generally no different than corporate ordinary income tax rates (35%)
- No taxable effect to the corporation upon distribution of its assets (net proceeds of the sale) to the corporation's shareholders following the sale
- If the corporation receives a promissory note, it may generally use the installment method to report gain on the sale

F. Tax Issues in an Asset Sale Involving a C Corporation (cont'd)

Shareholder Perspective

- Taxable income recognized by the shareholders on the liquidating distribution from the corporation following the sale
- Tax is based upon the difference between the distribution amount and the shareholders' basis
- Taxable at capital gains tax rate of 15% (assuming stock is held for 12 months)

F. Tax Issues in an Asset Sale Involving a C Corporation (cont'd)

Purchaser Perspective

- Purchaser's basis in the purchased assets is "stepped up" to equal the purchase price paid plus the assumed liabilities plus acquisition expenses
- Allocation among the assets purchased

Example

Facts: Target corporation sells its assets to purchaser for \$20,000. The assets include target corporation's accounts receivable, inventory, equipment and goodwill. Target corporation's basis in its assets is \$10,000.

Result: Target corporation pays capital gains tax on the \$10,000 gain realized through the sale of its assets. Assuming a 35% corporate rate on capital gains, target corporation pays \$3,500 in taxes on the sale, resulting in a liquidating distribution to the shareholder of \$16,500.

There is no taxable effect to target corporation upon distribution of \$16,500 to its shareholder. Assuming the shareholder's basis in the stock is \$1,000, the shareholder pays individual capital gains taxes (15%) on the \$15,500 gain resulting from the liquidating distribution. Allocation of the purchase price by purchaser to be discussed in next session.

G. Tax Issues in an Asset Sale Involving an S Corporation

Corporation Perspective

- Corporation does not pay any tax on the gain realized through the sale of its assets
- Corporate level gain flows through to the corporation's shareholders maintaining the corporate characteristics (e.g. capital gain or ordinary income)
- Corporate level gain flowing through to the shareholders increases the basis in the shareholders' stock eliminating or decreasing any tax to the shareholders on the liquidating distribution which follows the sale
- No taxable effect to the corporation upon distribution of its assets to the corporation's shareholders

G. Tax Issues in an Asset Sale Involving an S Corporation (cont'd)

Shareholder Perspective

- Tax is based upon the corporate level taxable income and gain which flows through to the shareholders from the corporation
- Generally no taxable income recognized by the shareholders on the liquidating distribution from the corporation due to the increase in the shareholder's basis

G. Tax Issues in an Asset Sale Involving an S Corporation (cont'd)

Purchaser Perspective

- Purchaser's basis in the purchased assets is "stepped up" to equal the purchase price paid plus the assumed liabilities plus acquisition expenses
- Allocation among the purchased assets

Example

Facts: Target corporation sells its assets to purchaser for \$20,000. The assets include target corporation's accounts receivable, inventory, equipment and goodwill. Target corporation's basis in its assets is \$10,000. Shareholder's basis in his stock is \$10,000.

Result: Target corporation pays no tax on the sale. The \$10,000 gain realized through the sale of the corporation's assets is passed through to the shareholder. Shareholder pays tax on the gain based upon its corporate characteristic (capital gain or ordinary income). Shareholder's basis in his stock increases \$10,000 to \$20,000.

There is no taxable effect to target corporation upon the \$20,000 distribution to its shareholder. Shareholder pays no tax on the distribution because shareholder's basis equals the distribution. Purchaser allocates the purchase price among the purchased assets.

H. Section 338(h)(10) Election in a Stock Sale

- Treats the corporation and the purchaser as if an asset sale occurred even though a stock sale occurred
- Only the purchaser and the corporation are taxed as if an asset sale occurred
- Election is made in order to step up the basis of the corporation's assets in a stock sale
- Corporation's basis in its assets is stepped up to equal the purchase price paid by the purchaser for the stock plus the corporation's liabilities plus acquisition costs
- Corporation is taxed as if it sold its assets in a "deemed asset sale" to itself
- Tax is based upon the fair market value of the corporation's assets as it relates to the corporation's basis

H. Section 338(h)(10) Election in a Stock Sale (cont'd)

- Corporation's NOL can generally be used to offset the gain on the "deemed asset sale"
- Corporation's "old" corporate attributes, such as NOL carryovers and tax accounting methods, are expunged
- Election must be made by the 15th day of the ninth month following the month in which the acquisition occurred

I. Consulting Agreements/Covenants Not to Compete

- Shift a portion of the purchase price to a form of compensation to the shareholders (e.g. consulting fees)
- Corporation does not pay any tax on the portion of the purchase price shifted to the consulting agreement or non-compete agreement
- Purchaser can deduct the payments under the consulting agreement in the year paid
- Otherwise, purchaser will have to allocate the consulting amount to goodwill and deduct it over 15 years
- Consulting payment must be reasonable under the circumstances; otherwise, it may be recharacterized and amortized as goodwill

I. Consulting Agreements/Covenants Not to Compete (cont'd)

- Non-compete agreement is treated as an “intangible”
- Purchaser can amortize the cost of the non-compete agreement over 15 years
- Amount treated by receiving shareholder as ordinary income

J. Issues to Consider from a Purchaser and Seller Perspective

- Seller and Purchaser generally at odds over structure being a stock sale or an asset sale
- Seller wants a stock sale
 - one level of taxation at long term capital gains rate of 15%
 - No retention of liabilities
- Purchaser wants an asset sale
 - Limitation of assumed liabilities
 - Step up basis of purchased assets
- THINK CREATIVELY WHEN STRUCTURING THE DEAL!!!!