Tax Considerations in Buying or Selling a Business

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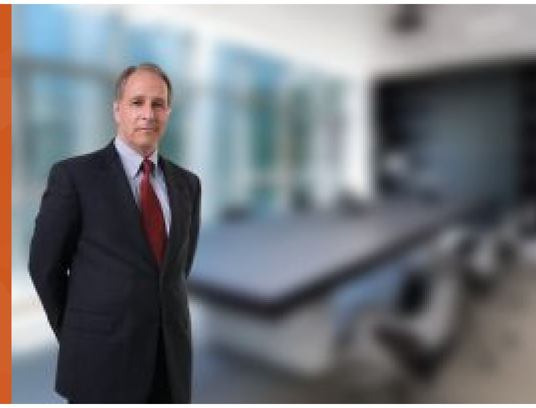
April 04, 2018



I. Consequences Generally.[1]

The after-tax consequences of buying or selling a business can vary significantly depending on the tax classification of the entity conducting the business (referred to in this outline as the "Company") and on how the sale is structured. Often, what is good for one party to the sale is bad for the other. The structure of the sale, therefore, is often driven by the relative bargaining positions of the parties and, in any event, may affect the price paid by the purchaser.

A. Corporation.

1. Stock sale.

If the Company is a corporation, its stockholders will generally prefer to structure the transaction as a purchase and sale of their stock (rather than as a purchase and sale of the Company's assets).[2] That way, gain on the transaction is taxed only once (at the stockholder level in amounts equal to the differences between their amounts realized in the sale and their adjusted bases in their shares) and is capital gain (long-term in the case of any stockholder who has held his or her stock for more than a year).[3] Any losses recognized by the stockholders generally are capital losses (except to the extent they can be treated as ordinary losses under Code Section 1244).[4] The purchaser, on the other hand, may not want to purchase stock because, except as described in I.a.3. below ("Stock sale treated as asset sale"), a stock purchase has no effect on the tax bases of the Company's assets. Instead, the purchaser takes a basis in the stock purchased equal to the amount it pays for the stock, and the taxable income inherent in the Company's assets remains inherent in the assets. Stock is not amortizable.[5]

a. Form of stock sale. A stock sale may be effected by a direct purchase and sale of the stock of the Company or by a "reverse subsidiary merger." In a reverse subsidiary merger, the purchaser forms a transitory subsidiary, capitalizes the transitory subsidiary with the purchase price (which may include borrowed money if the purchase will be leveraged), and then merges the transitory subsidiary into the Company. When the dust settles, the selling stockholders have the purchase price, and the Company is owned by the purchaser.[6]

2. Asset sale.

At least from a tax standpoint, if the Company is a corporation, the purchaser will generally prefer to structure the transaction as a purchase and sale of the Company's assets (rather than as a purchase and sale of the stock of the Company).[7] That way, the purchaser can "write up" the tax bases of the Company's assets and thereby report greater depreciation and amortization deductions with respect to, and smaller amounts of gain (or greater amounts of loss subject to any applicable limitations) on re-sales of, the purchased assets.[8] The Company's stockholders, on the other hand, may not want to structure the transaction as an asset sale because (i) if the Company is a C corporation, the Company will be subject to tax on its gain from the sale, and the stockholders will then also be subject to tax on gains they have when they receive the net proceeds of the sale from the Company, so that there can be taxable gain from the sale at both the Company and stockholder levels, or (ii) if the Company is an S corporation, some or all of the Company's gain may be reportable by the stockholders as ordinary income depending on the Company's assets and the allocation of the purchase price (and, if the Company holds assets with built-in gain subject to tax under Code Section 1374, the built-in gain will be subject to tax at both the Company and stockholder levels, with a deduction for the stockholders of the tax payable by the Company).[9]

a. Form of asset sale. An asset sale may be effected by a direct purchase and sale of the Company's assets or by a merger of the Company into the purchaser or a subsidiary of the purchaser.[10]

b. Purchase price allocation. In an asset sale, the Company is treated as selling, and the purchaser is treated as buying, the various Company assets separately for allocable portions of the aggregate purchase price. The aggregate purchase price is allocated among the various Company assets by class and fair market value under rules set forth in the Regulations under Code Sections 1060 and 338.[11] Particularly if the Company is an S corporation, the Company's stockholders will prefer to allocate the purchase price so as to maximize the amount of their income from the sale that is long-term capital gain. The purchaser, on the other hand, will likely want to allocate as much purchase price as possible to assets that are eligible for bonus depreciation (or have short depreciation or amortization schedules) or that are likely to turn over in the short term.

3. Stock sale treated as asset sale.

If the Company is an S corporation (or a subsidiary member of a group of corporations filing a consolidated return) and its stockholders sell at least 80% (by vote and value) of the outstanding stock of the Company (in a single transaction or a series of transactions within a period of twelve months), the sale may be treated for tax purposes as a sale of the Company's assets by means of an election under Code Section 338(h)(10) or Code Section 336(e).[12] Such an election is generally made by mutual agreement of the parties (if the Company is an S corporation, however, all of its stockholders must consent to the election). If such an election is made, the Company's stockholders determine their tax consequences as if the Company had (i) sold its assets for the amount paid for the Company stock in the qualifying sale or sales (grossed up if less than all of the outstanding stock of the Company has been sold in such qualifying sale or sales) plus the amount of the Company's liabilities and then (ii) liquidated, distributing its assets (the proceeds of its deemed asset sale) to the stockholders.[13] The purchaser, on the other hand, is deemed to acquire a "new" Company with stepped-up asset bases. The election may be disadvantageous to the Company's stockholders for the reasons noted under "Asset sale" above (possibility of ordinary income and, if the Company holds assets with built-in gain subject to tax under Code Section 1374, double-taxation).[14]

4. Reorganization.

If the Company and the purchaser are corporations, the transaction may be "tax-free" entirely or in part to the Company's stockholders if it qualifies as a "reorganization" under Code Section 368.[15] In that case, the Company's stockholders generally recognize their realized gains under Code Sections 354 and 356 only to the extent of any of their purchase price that is paid in cash or in property other than qualifying stock of the purchaser (or the purchaser's parent corporation).[16] Any realized gain they avoid recognizing remains inherent in the qualifying purchaser (or purchaser parent) stock they receive in the transaction.[17] The purchaser writes up the tax bases of the Company's assets under Code Section 362(b) only to the extent of any gain recognized by the

Company.[18]

B. Partnership.[19]

1. Equity interest sale.

If the Company is a partnership for tax purposes and the Company's owners sell their equity interests in the Company to the purchaser, the Company's owners are required to report, under Code Section 751(a), the ordinary income they would have had to report if the Company had sold its "unrealized receivables" (which include, among other things, depreciation recapture inherent in any depreciable property) and "inventory" (which includes, in addition to traditional inventory, property income from the sale of which would be ordinary) at fair market value. Any remaining gain or loss a selling owner of the Company may have on the sale is generally capital gain or loss under Code Section 741.[20] The purchaser, on the other hand, is treated as having purchased the Company's assets if the purchaser purchases all of the outstanding interests in the Company.[21]

2. Asset sale.

In an asset sale, the Company is treated as selling, and the purchaser is treated as buying, the various Company assets separately for allocable portions of the aggregate purchase price. Thus, because the Company's owners report their shares of the Company's income or loss directly under Code Section 702 (with character passing through as well), the mix to the Company's owners of capital gain (or loss) and ordinary income (or loss) will depend on the nature and adjusted bases of the Company's assets and the allocation of the purchase price. Like S corporation stockholders in an asset sale, the Company's owners will prefer to allocate the purchase price so as to maximize the amount of long-term capital gain (or ordinary loss) to be reported by them on the sale. The purchaser, on the other hand, will likely want to allocate as much purchase price as possible to assets that are eligible for bonus depreciation (or have short depreciation or amortization schedules) or that are likely to turn over in the short term.

3. Inapplicability of reorganization rules.

The reorganization rules of Section 368 and its ancillary provisions do not apply to partnerships. Accordingly, if the Company is a partnership for tax purposes, it may not be acquired for stock of a corporate acquiror on a tax-deferred basis under those rules.[22] While conversions of partnerships to corporations can often be effected without the recognition of income, a conversion of the Company effected as part of a plan culminating in the receipt by the Company's owners of stock of a corporate acquiror can be disregarded as transitory (or be taxable for failure to satisfy Section 351), particularly if a transaction with the prospective acquiror has advanced too far.[23]

C. Suspended Losses.

If the Company is a C corporation with a net operating loss, the loss may be limited as to its usefulness going forward under Code Section 382 if the transaction is structured as a stock sale or never used if the transaction is structured as an asset sale (to the extent not used against income from the asset sale).[24] If the Company is an S corporation or tax partnership, suspended losses of the owners from the Company may be freed up (including for use against income from the sale) if the sale (i) in the case of losses suspended under a basis limitation or the "at risk" rules of Code Section 465, increases owner bases or amounts at risk (in particular, through allocations of income from the sale) or (ii) in the case of losses suspended under the "passive activity loss" rules of Code Section 469, results in the affected owners having made taxable dispositions of their interests in the activity that generated their losses.[25]

II. Deferred or Contingent Payments.

It is not uncommon for a portion of the purchase price to be paid over time or in the form of an "earn-out" as certain goals or milestones are met (with the deferred payment obligation evidenced by a note or by the purchase and sale agreement). In addition, a portion of the purchase price may be held back or deposited into an escrow account to secure obligations of the Company or its owners to indemnify the purchaser for breaches of representations, warranties and covenants.

A. Original Issue Discount.

If a deferred portion of the purchase price does not bear an adequate interest rate, part of the deferred portion may be recharacterized as interest under the original issue discount rules of Code Sections 1272 through 1275 and the Regulations thereunder. In addition, interest that is not payable at least annually as it economically accrues may have to be reported as it accrues on the basis of a constant yield to maturity rather than as it is actually paid (so that the Company or its owners may have to report interest income for a year in which they receive no payments).

1. Contingent payments.

In the case of a contingent deferred payment, the portion of the payment that is interest is generally the amount by which the payment exceeds the present value of the payment discounted back to the closing date from the date it becomes fixed at a "test rate" applicable to the sale (with the present value of the payment being principal). Contingent interest is generally reported as it becomes fixed (subject to special rules that apply when the contingent interest is payable more than six months after becoming fixed).

B. Installment Method.

Generally, a seller's gain on a deferred payment sale is reported under the installment method of Code Section 453 unless the seller elects not to use the method. Under the installment method, the seller computes the percentage (referred to as the "gross profit ratio") which his or her overall profit on the sale (exclusive of interest) represents of the overall amount he or she will receive from the sale (other than as interest, and excluding certain "qualifying indebtedness" to be assumed or taken subject to by the purchaser to the extent not in excess of the seller's adjusted basis in the property being sold). He or she then multiplies each "payment" he or she receives by that gross profit ratio to determine the portion of the payment that is gain. The portion of any payment that is not treated as gain is recovered basis.

1. Contingent payments.

The contingent payment provisions of the installment sale rules make some unfriendly assumptions.[26] For instance, if there is a cap on the amount that the seller can receive, the seller computes his or her gross profit ratio by assuming that he or she will receive the maximum amount he or she can receive. If there is no cap on the amount that the seller can receive but there is a fixed period over which the seller can receive payments, the seller does not compute a gross profit ratio and instead allocates his or her adjusted basis in the property being sold to the years in which he or she may receive payments in equal annual portions (or in accordance with an arithmetic component consistent with the manner in which payments may be made unless it is inappropriate to assume that payments will be made in accordance with the component) and then subtracts the portion allocated to any year in the payment period from the payment made for that year. In any event, the assumptions required by the Regulations can overstate the portions of the early payments to the seller constituting gain and leave the seller with unrecovered basis after he or she has received all the payments to be made by the purchaser.[27]

2. Escrow and security arrangements.

If a portion of the purchase price is deposited into an escrow account to secure representations and warranties of the seller, the deposit into the escrow account is generally not treated as a "payment" requiring the reporting of gain for the seller under the installment method. Instead, when an amount is released to the seller from the escrow account, the present value of the released amount (discounted back to closing at the applicable "test rate") is a payment, and the balance is interest. Notwithstanding the general rule, care must be taken in structuring escrow and other security arrangements to avoid creating "payments."

3. Ineligible income.

Depreciation recapture under Code Sections 1245 and 1250 (including by way of Section 751) and gains from sales of inventory and publicly traded stock are not eligible for reporting under the installment method.[28] Ordinary income of sellers of interests in tax partnerships (attributable to assets of the partnerships gains from the sale of which would be ineligible for installment method reporting) generally may not be reported under the installment method. Accordingly, care should be taken in structuring deferred payment sales of interests in tax partnerships.[29]

4. Section 453A interest charge.

Under Code Section 453A, a seller who holds more than $5 million in installment obligations may be subject to an interest charge on the deferred tax liability with respect to the balance in excess of that amount.

5. S corporations and Sections 453(h) and 453B(h).

If, within twelve months after adopting a plan of liquidation (to which Code Section 331 applies), an S corporation sells its assets and distributes an installment obligation from the sale to its stockholders in complete liquidation, (i) under Code Section 453B(h), the corporation's distribution of the installment obligation to its stockholders does not trigger the gain inherent in the obligation, and (ii) under Section Code 453(h), the stockholders may report their gains under the installment method as they receive payments on the distributed obligation as if they had sold their shares for the obligation (with the character of the gain being determined, under Regulations to be issued, by reference to the gain that would have been recognized by the S corporation had it received the payments).[30] If the purchaser would purchase the S corporation's assets for cash and an installment obligation, it might be better for the S corporation's stockholders to have the cash that would otherwise be paid at the closing of the sale instead be included in the amount of the installment obligation and then paid on the installment obligation shortly after the S corporation has sold its assets and distributed the installment obligation in completion of its liquidation.[31]

6. Section 338(h)(10) elections and notes.

If the purchaser in a stock purchase for which a Section 338(h)(10) election is made (see I.a.3., "Stock sale treated as asset sale," above) pays part or all of the purchase price for the stock with a note, "old" Company is treated as having received the note in its deemed asset sale (with the deemed asset purchaser being the obligor) and then as having distributed the note in its liquidation. As a result, the installment method applies to the note subject to any other applicable exceptions.[32]

7. Distribution of installment obligation by partnership.

Under Regulations Section 1.453-9(c)(2), a partnership's distribution (governed by Code Section 731) of an installment obligation should not trigger the gain inherent in the obligation under Code Section 453B.

C. Reorganization.

If the transaction is intended to qualify as a reorganization under Code Section 368, care must be taken to ensure that the deferred payment arrangement does not jeopardize that qualification.[33]

III. Post-transaction Equity Interests of Company Owners.[34]

The parties may desire that one or more owners of the Company continue to hold equity interests in the Company's business after the sale.

A. Purchase of only a portion of the Company's outstanding equity.

A purchaser may be willing to purchase only a portion of the outstanding equity of the Company from the existing Company owners so that, going forward, the Company is owned by the purchaser and one or more of the Company's pre-existing owners.

1. Company is a corporation.

If the Company is a corporation, the selling stockholders have capital gains or losses equal to the differences between the amounts they receive for the shares they sell and their adjusted bases in those shares.[35] The purchaser takes a basis in the shares it purchases equal to the amount it pays for the shares.[36] The purchase has no effect on the tax bases of the Company's assets.[37]

2. Company is a partnership.

If the Company is a partnership for tax purposes, on the other hand, the selling owners have ordinary income under Code Section 751(a) in the amounts they would have been required to report with respect to their transferred equity interests if the Company had sold its "unrealized receivables" (which include, among other things, depreciation recapture inherent in any depreciable property) and "inventory" (which includes, in addition to traditional inventory, property income from the sale of which would be ordinary) at fair market value (with any remaining gain or loss of the selling owners in the transaction being capital gain or loss).[38] In addition, if the Company has an election under Code Section 754 in effect, the purchaser will be able to write up its share of the basis of each of the Company's assets.[39]

B. Stock sale with rollover.

Rather than purchase only a portion of the outstanding equity of the Company, the purchaser may prefer that the purchase be of 100% of the outstanding equity of the Company so that the Company becomes a wholly-owned subsidiary of the purchaser. In that case, one or more of the owners of the Company may receive equity of the purchaser for some or all of their Company equity. Owners of the Company who exchange Company equity for purchaser equity generally want to avoid reporting gain with respect to the purchaser equity they receive in the transaction.

1. Purchaser is a corporation.

If the purchaser is a corporation, the exchange of equity of the Company for stock of the purchaser generally must satisfy the requirements of Code Section 351 to be nontaxable to any extent.[40] For the exchange to satisfy the requirements of Code Section 351, the stock of the purchaser may not be "nonqualified preferred stock." In addition, the Company owners who exchange Company equity for stock of the purchaser must hold, as of the time immediately after the exchange either individually or together with one or more other persons who contemporaneously transfer money or other property to the purchaser for stock of the purchaser, at least 80% of (i) the total combined voting power of all classes of stock of the purchaser entitled to vote and (ii) at least 80% of the total number of shares of all other classes of stock of the purchaser.[41] If a Company owner receives, in exchange for his or her Company equity, only stock of the purchaser and the transfer satisfies the requirements of Code Section 351, the Company owner is not taxable on the transfer and, subject to certain limitations, takes a basis in the purchaser stock he or she receives equal to his or her adjusted basis in the Company equity he or she transferred to the purchaser. If a Company owner receives cash ("boot") from the purchaser in addition to stock, Code Section 351 can still apply (if its requirements are otherwise satisfied), but the Company owner recognizes his or her realized gain on the exchange (which is the value of the purchaser stock plus the amount of cash he or she receives from the purchaser minus his or her adjusted basis in the Company equity he or she transfers to the purchaser) to the extent of the boot (with the boot being subtracted from, and the recognized gain being added to, the basis the Company owner takes in the stock he or she receives from the purchaser).[42] The purchaser, on the other hand, and subject to certain limitations, takes a basis in the Company equity it receives from the Company owner equal to the Company owner's adjusted basis in the Company equity plus the amount of gain recognized by the Company owner.[43]

2. Purchaser is a tax partnership.

If the owners of the Company transfer their equity of the Company for cash and equity of an entity that is a partnership for tax purposes, the extent to which the transfer is non-taxable to the owners is generally determined under Code Sections 707 and 721.[44] In that case, the transfer to the partnership can be bifurcated into taxable sale and non-taxable (generally) contribution components, with the adjusted basis of any Company owner in the Company equity he or she transfers to the partnership being apportioned between the components based on the relative values of what he or she receives in the components.[45] The Company owners then generally take bases in the purchaser equity they receive in the contribution components equal to the portions of their adjusted bases in their Company equity apportioned to the contribution components. The purchaser, on the other hand, generally takes a basis in the Company equity it receives from the Company owners equal to the amounts it paid for the equity in the sale components plus the Company owners' adjusted bases in the Company equity apportioned to the contribution components.

C. Asset sale with rollover.

Adding a rollover to an asset sale can produce both a partial exclusion of gain for the Company and its owners and a partial basis step-up for the purchaser.[46] These types of transactions can be particularly beneficial if the Company is an S corporation or tax partnership.[47] Unfortunately, if the Company is a corporation and is able to avoid recognizing some of the income and gain inherent in its assets in an asset transfer for equity, it generally may not liquidate without triggering the unrecognized gain (so that it must stay in existence after the transaction).[48]

1. Purchaser is a corporation.

If the Company is an S corporation or tax partnership and transfers its assets to a purchasing corporation for stock of the purchasing corporation and cash (the cash, again, being referred to as "boot"), and if the transfer otherwise satisfies the requirements of Code Section 351, the stock and boot are allocated among the transferred assets based on their relative fair market values, and the tax consequences of the transfer to the Company are determined under the Section 351 rules on an asset-by-asset basis.[49] The character of the gain recognized by the Company (and passed through to the Company's owners if the Company is an S corporation or tax partnership) with respect to any asset depends on the nature of the asset in the hands of the Company. For example, the recapture rules of Code Section 1245 may cause all or a portion of the gain recognized with respect to any depreciated or amortized asset to be ordinary income. Subject to certain limitations, the Company generally takes a basis in the purchaser stock it receives for any asset equal to (i) its adjusted basis in the asset, (ii) minus the amount of cash it receives with respect to the asset, (iii) plus the amount of gain it recognizes on the transfer of the asset. The basis the purchaser takes in any asset it acquires from the Company for shares of its stock and cash generally equals the Company's basis in the asset increased by the amount of gain recognized by the Company with respect to the asset.

2. Purchaser is a tax partnership.

If the Company transfers its assets for cash and equity of an entity that is a partnership for tax purposes, the tax consequences to the Company will generally be determined under

Code Sections 707 and 721.[50] In that case, the transfer to the partnership can be bifurcated into taxable sale and non-taxable (generally) contribution components, with the adjusted bases of the Company in its assets being apportioned between the components based on the relative values of what it receives in the components. The character of the gain recognized by the Company (and passed through to the Company's owners if the Company is an S corporation or tax partnership) with respect to any asset sold in the sale component depends on the nature of the asset in the hands of the Company. The Company then generally takes a basis in the purchaser equity it receive in the contribution component equal to the portion of its adjusted basis in its assets apportioned to the contribution component. The purchaser, on the other hand, generally takes bases in the assets it receives from the Company equal to the amounts it paid for the assets in the sale component plus the Company's adjusted bases in the assets apportioned to the contribution component.

D. Bifurcated Transaction.[51]

It may be beneficial to structure an acquisition with a rollover feature so that (i) the portion of the Company equity or assets to be exchanged for equity is transferred to a parent-level entity in the purchaser group in exchange for parent-level equity and (ii) the remaining Company equity or assets are sold for cash to a subsidiary-level entity in the purchaser group (and with the Company equity or assets transferred to the parent-level entity for parent-level equity being contributed by the parent to the subsidiary). For example, if the purchaser equity is to be stock of a corporation received by Company owners in a transaction governed by Code Section 351, such a bifurcation might result in less income and gain for the Company and its owners than would otherwise result if the transferred Company equity or assets were transferred to a single corporation for stock and cash boot. Alternatively, a structure using a tax partnership for the parent-level entity and a corporation for the subsidiary-level entity might avoid the applicability of the Code Section 351 "control" requirement while leaving the purchaser in control of the corporation through rights set forth in the governing documents for the partnership rather than in charter and other governing documents of the corporation.[52]

IV. Employees and Other Service Providers.

A. Outstanding Options and Restricted Equity.

Often, employees and other service providers of the Company have Company options or shares of restricted Company equity.

1. Option holders.

If an option holder receives cash or purchaser equity for the option, he or she generally recognizes the amount of cash or the value of any purchaser equity he or she receives (less any amount he or she pays to exercise the option) as ordinary income (although, if the option holder receives purchaser equity that is substantially nonvested, the tax consequences are postponed until the equity ceases to be substantially nonvested unless the option holder makes a timely Section 83(b) election with respect to the purchaser equity).[53] Any deferred or contingent payments made to the option holder generally will not be subject to Code Section 409A if the payments are made on the same schedule and on the same terms and conditions as they are made to the Company's equity holders and are fully paid within five years after the sale.[54]

2. Restricted equity holders.

The consequences of the transaction to a holder of substantially nonvested Company equity generally depend on whether or not the holder has made a timely Section 83(b) election with respect to the Company equity (unless, at least under current law, the restricted Company equity is a partnership profits interest deemed to be owned by the holder notwithstanding his or her failure to make a Section 83(b) election). If the holder did not make a timely Section 83(b) election with respect to the Company equity (unless, at least under current law, the Company equity is a partnership profits interest deemed to be owned by the holder notwithstanding his or her failure to make a Section 83(b) election), he or she generally recognizes ordinary income equal to the amount of cash and the value of any purchaser equity he or she receives for the Company equity (less the amount he or she paid for the Company equity). If any purchaser equity received by the holder is itself substantially nonvested upon receipt, however, the income with respect to the purchaser equity is deferred until the purchaser equity ceases to be substantially nonvested (at which time the income is determined with reference to the then value of the equity) unless the holder makes a timely Section 83(b) election with respect to the equity. If the holder made a timely Section 83(b) election with respect to the restricted Company equity (or, at least under current law, the restricted Company equity is a partnership profits interest deemed to be owned by the holder notwithstanding his or her failure to make a Section 83(b) election), the holder generally participates in the transaction as the owner, for tax purposes, of the restricted Company equity.[54]

B. Golden Parachutes.

Special rules apply under Sections 280G and 4999 to payments (referred to as "parachute payments") in the nature of compensation by a corporation to a "disqualified individual" that (i) are contingent on a change of control of the corporation and (ii) have an aggregate present value equal to at least three times the disqualified individual's "base amount." A "disqualified individual" is an individual who performs personal services for the corporation and who is either an officer or stockholder (holding more than 1% by value of the corporation's stock) of the corporation or is among (or would be among, if he or she were an employee) the highest paid 1% or, if less, 250 employees of the corporation. An individual's "base amount" is his or her average annualized compensation from the corporation during the five year period before the year of the change of control. Under the rules, an "excess parachute payment" (the amount by which any parachute payment exceeds an allocable portion of the disqualified individual's base amount) is non-deductible by the corporation and is subject to a 20% excise tax in the hands of the disqualified individual.[55]

1. Accelerated vesting.

The acceleration of the vesting of Company options or restricted stock can give rise to parachute issues. If vesting after the change of control would have depended only on the continued performance of services for the Company for a specified period of time, however (and acceleration is attributable, at least in part, to services performed before the change of control), the amount that must be taken into account as a payment contingent on the change of control of the Company is limited to the time value of the acceleration (plus an amount reflecting the lapse of the obligation to continue performing services).[56]

2. Small business corporations.

The parachute rules will not apply to payments with respect to the Company if the Company meets the "small business corporation" definition of Section 1361(b) that it would have to meet to qualify as an S corporation (without regard to the requirement that it have no nonresident aliens as stockholders).

3. Stockholder approval.

If the Company is private, the applicability of the parachute rules can be avoided by subjecting what would otherwise be parachute payments to approval by the Company's stockholders. Unfortunately, for the approval to achieve its purpose, the right of the disqualified individual to receive the payment must be made contingent on the approval.

C. Covenants Not to Compete; Consulting and Employment Arrangements.[57]

Key personnel of the Company may be asked not to compete, either individually or on behalf of another entity. Alternatively (or additionally), they may be asked to provide services to the purchaser as employees or consultants. Non-compete, employment and consulting payments are ordinary income in the hands of their recipients.[58]

For more information, please contact **Chip Wry**.

Footnotes.

1. References in this article to (i) the "Code" are to the Internal Revenue Code of 1986, as amended, and (ii) the "Regulations" are to the Income Tax Regulations under the Code.

2. Even from a non-tax standpoint, the stockholders may prefer a stock sale because the purchaser assumes the economic burden of any Company liabilities subject to any continuing obligations of the stockholders to indemnify the purchaser for breaches of representations and warranties under the purchase agreement. A stock sale might also be desirable, for all parties, if the Company has assets (such as contract rights, licenses or permits) that may be difficult to transfer.

3. Currently, the maximum federal rates applicable to a U.S. individual's ordinary income and long-term capital gains (and qualified dividends) are 37% and 20%, respectively, although (i) certain ordinary "qualified business income" of an individual may be eligible for a 20% deduction, (ii) higher long-term capital gain rates can apply to certain types of long-term capital gain, and (iii) individuals can be subject to an additional 3.8% tax on their "net investment income," which can include, among other things, capital gains from dispositions of stock. If the stock held by an individual stockholder of the Company is "qualified small business stock" under Code Section 1202, and if the stockholder acquired the stock after September 27, 2010 and has held the stock for more than five years, however, the stockholder may exclude an amount of his or her gain on the sale of the stock not exceeding the greater of $10 million ($5 million for married individuals filing separate returns) or ten times the stockholder's adjusted basis in the stock. Alternatively, if the stockholder has held the stock for more than six months, the stockholder may roll his or her gain into newly acquired "qualified small business stock" under Code Section 1045. If the Company is an S corporation, stock of the Company cannot be "qualified small business stock," and, if the S corporation owns "collectibles," a portion of the stockholders' gains may be taxable at a higher capital gain rate than would otherwise apply.

4. Generally, individuals may deduct their capital losses only against their capital gains plus small amounts of their ordinary income. Code Section 1244 permits individuals to report up to $50,000 ($100,000 in the case of a husband and wife filing a joint return) of their losses for any year from sales or exchanges of "Section 1244 stock" as ordinary losses. "Section 1244 stock" is stock issued for money or other property by a "small business corporation" (the corporation may not have received more than $1,000,000 in money or other property for stock) that satisfies an active gross receipts test.

5. Even if stock issued by the Company could otherwise be "qualified small business stock" eligible for the benefits of Code Section 1202, stock purchased by the purchaser from a stockholder of the Company rather than from the Company itself is not qualified small business stock. For stock to be qualified small business stock, it must, among other things, be purchased from the issuing corporation and not from a stockholder of the corporation. Even if the purchaser purchases stock of the Company from the Company and the Company uses the proceeds of the purchase to fund redemptions from the selling stockholders, the stock acquired by the purchaser will not be qualified small business stock if the value of the redeemed stock exceeds 5% of the value of the outstanding stock of the Company as of the date one year before the purchaser's purchase of stock from the Company.

6. See Rev. Rul. 73-427, 1973-2 CB 301 and Rev. Rul. 78-250, 1978-1 CB 83. Any shares that are purchased in the merger with existing cash of the Company or proceeds of debt for which the

Company becomes liable (whether by incurring the debt directly or assuming it from the transitory subsidiary as part of the merger transaction) are treated as having been redeemed by the Company. Any shares so redeemed from a Company stockholder are treated as having been sold by the stockholder if the redemption, in conjunction with any sale of other shares by the stockholder in the merger, satisfies one of the Code Section 302(b) tests. From a corporate law standpoint, the reverse subsidiary merger generally allows for the purchase of all of the stock of the Company without the approval of all of the Company's stockholders. Generally, though, dissenting stockholders have "appraisal" rights entitling them to receive a judicially determined fair price (which can be addressed with "drag-along" provisions of agreements among the Company's stockholders).

7. From a non-tax standpoint, the purchaser may prefer an asset purchase as well so that the economic burden of the Company's liabilities remains with the Company and, in effect therefore, the Company's stockholders.

8. Under Code Section 168(k) as amended by the Tax Cuts and Jobs Act of 2017 (the "2017 Act"), taxpayers can deduct 100% of the cost of "qualified property" they place in service before January 1, 2023 in the year in which they place the property in service (the percentage of the cost that may be expensed up front phases down from 80% to 20% for qualified property placed in service during the years 2023 through 2027). "Qualified property" is generally defined as tangible property with a recovery period of 20 years or less, but certain other types of property (including software that is not an "amortizable Section 197 intangible") can qualify as well. Significantly for purposes of acquisition transactions, and also by way of the 2017 Act, property can now be qualified property eligible for expensing under Code Section 168(k) even if it is not new in the hands of the taxpayer so long as it was not previously used by the taxpayer and was not acquired by the taxpayer from a related person or in a carryover basis transaction. The 2017 Act also increased the amount that a taxpayer may expense in any year on account of purchases of "Section 179 property" (generally, tangible property and certain "shrink wrap" computer software) to $1,000,000 (the cost limit beyond which the deductible amount phases out on a dollar-for-dollar basis was increased to $2,500,000).

9. Currently, a C corporation is taxed federally on its income at a flat rate of 21% without regard to the character of the income.

10. See Rev. Rul. 69-6, 1969-1 CB 104. In an asset sale effected by a merger of the Company into the purchaser (or a subsidiary of the purchaser), the purchaser (or subsidiary of the purchaser) assumes any tax liabilities of the Company (including any tax liability resulting from the merger) by operation of law.

11. Those Regulations establish seven classes of assets. The first two classes consist of cash, cash equivalents, actively traded personal property, certificates of deposit and foreign currency. The third class consists of accounts receivable, mortgages and credit card receivables arising in the ordinary course of seller's trade or business. The fourth class consists of inventory or property held primarily for sale to customers in the ordinary course of the seller's trade or business. The fifth class consists of all assets not in any of the other classes (such as machinery, equipment and real estate). The sixth class consists of Section 197 intangibles other than goodwill and going concern value. The seventh class consists of goodwill and going concern value. In general, purchase price is allocated sequentially by class to the extent of the fair market value of the assets of the class.

12. For a Section 338(h)(10) election to be made, there must be a single purchaser and that purchaser must be a corporation. In either case, stock acquired in a transaction to which Code Section 351 (or any of certain other non-recognition provisions) applies does not count toward satisfying the 80% threshold. In addition, if holders of 50% or more of the Company's stock before the purchase own 50% or more of the stock of the purchaser after the purchase, the

purchase may be treated as a Section 304 transaction.

13. See Regulations Section 1.338(h)(10)-1. Thus, the Company's stockholders do not report separate gains or losses on the sales of their shares.

14. The election may also be disadvantageous to the Company's stockholders if their stock bases are greater than the Company's asset bases.

15. There are a limited number of ways for a transaction to qualify as a reorganization. A detailed discussion of those ways is beyond the scope of this article. Each way, however, requires (among other things) that a minimum percentage of the price paid for the Company be paid in the form of qualifying stock of the purchaser (or its parent). The minimum percentage ranges from 40% for a straight (i.e., not a reverse subsidiary) merger (an "A" reorganization) to 100% for a simple stock-for-stock swap (a "B" reorganization). Sections 351 and 721 can also provide "tax free" treatment entirely or in part if the transaction involves the contribution of stock or assets of the Company to a corporation or partnership for equity.

16. This cash or other property, like cash and other non-qualifying property received in a Section 351 or Section 721 transaction, is also sometimes referred to as "boot."

17. If the Company stock is "qualified small business stock" under Code Section 1202, the stock of the purchaser (or its parent) received by a Company stockholder in the reorganization is also treated, under Section 1202(h)(4), as qualified small business stock (if it otherwise would not have been) received by the Company stockholder on the date he or she acquired his or her Company stock. The amount of gain that may be treated as gain from the sale of qualified small business stock upon the subsequent sale of the stock of the purchaser (or its parent) by the Company stockholder, however, is limited to the amount of gain built into the Company stock as of the time of the exchange of the Company stock for the purchaser (or purchaser parent) stock.

18. Because any gain in a reorganization on account of boot is usually reported by the Company's stockholders rather than by the Company, the purchaser generally gets no basis increase in the Company's assets.

19. Entities classified as partnerships for tax purposes include LLCs, limited partnerships, limited liability partnerships and general partnerships (so long, in each case, as they have more than one owner and have not elected to be classified as corporations).

20. The selling owners' shares of the Company's liabilities are included in their selling prices. As a result of the bifurcated treatment of the sale, depending on the nature of Company's assets and the adjusted bases and values of the assets, the Company's owners can have to report both ordinary income and capital gain (or even capital loss) on the sale.

21. See Rev. Rul. 99-6, 1999-1 CB 432.

22. Section 351 or Section 721 may provide "tax free" treatment entirely or in part, however, if the transaction involves the contribution of equity or assets of the Company to a corporation or partnership for equity.

23. See, for example, Rev. Rul. 70-140, 1970-1 CB 73.

24. Section 382 can also limit the usefulness of certain built-in losses that have not yet been recognized.

25. Because suspended losses retain their original character, investors in an S corporation or tax partnership whose shares of the entity's losses are suspended under the "passive activity loss" rules of Section 469 may ultimately be able to claim any losses they actually have on their investments as ordinary losses when the losses free up. Outside of Section 1244, their investment losses generally are capital losses when they sell or otherwise dispose of their investments in the entity if the entity is a C corporation.

26. See Regulations Section 15A.453-1(c).

27. Depending on the circumstances, sellers in contingent payment sales may want to consider electing out of the installment method or requesting an alternate reporting schedule.

28. See Code Sections 453(b)(2), 453(i) and 453(k)(2)(A).

29. See Rev. Rul. 89-108, 1989-2 CB 100. Rev. Rul. 68-13, 1968-1 CB 195 provides that, where multiple assets are sold for cash and a note, the parties can agree on the allocation of the cash and the note among the various assets (for example, the seller might want to allocate the cash to assets ineligible for installment sale reporting and the note to assets eligible for installment sale reporting so as to minimize the amount of income reported for the year of the sale). In the absence of such an agreement, the cash and note are allocated on a pro rata basis among the various assets.

30. If the corporation were a C corporation, the stockholders could report their gains under the installment method as they receive payments on the distributed obligation as if they had sold their shares for the obligation, but the distribution of the obligation by the corporation would require the corporation to recognize the gain inherent in the obligation. That is, Section 453(h) would apply to the stockholders, but Section 453B(h) would not apply to the corporation.

31. Cash paid to the S corporation by the purchaser can increase the amount of S corporation gain to be reported by the stockholders for the year of the S corporation's liquidation. The gain increases the stockholders' bases in their shares. If a stockholder receives cash and an installment obligation in the liquidation of the S corporation, the stockholder's stock basis (as increased by his or her share of the gain recognized by the S corporation on the sale) is allocated between the cash and the installment obligation in proportion to the relative amounts of the cash and the installment obligation. The stockholder has additional gain for the year of the liquidation to the extent that the cash he or she receives exceeds the portion of his or her stock basis allocable to the cash. The portion of his or her stock basis allocable to the installment obligation becomes his or her basis in the installment obligation, with his or her gross profit ratio being (i) the amount of the installment obligation minus his or her basis in the obligation over (ii) the amount of the obligation. Depending on the circumstances, moving the cash payment from a payment at the closing of the sale to an initial payment on the installment obligation post-liquidation can avoid additional gain to the stockholders for the year of the sale and liquidation resulting from their receipt of cash from the corporation for shares with lesser bases.

32. See Regulations Sections 1.338(h)(10)-1(d)(8) and 1.338(h)(10)-1(e), example 10. The Regulations under Code Section 336(e) indicate that the rule applies in transactions governed by Section 336(e) elections as well.

33. See Rev. Proc. 84-42, 1984-1 CB 521.

34. The discussions in this Section III. assume the transaction is not a "reorganization" under Code Section 368. Among other things, for a transaction to be a reorganization, the parties must be corporations (and their stockholders) and a minimum percentage of the purchase

consideration must be qualifying stock of the purchaser or the purchaser's parent corporation. It is also assumed in this Section III. that the Company's owners will not hold 50% or more of the equity of the purchaser.

35. If the purchases from existing stockholders are structured as redemptions, a selling stockholder will have to satisfy the requirements of Code Section 302(b) to be deemed to have sold his or her shares rather than to have received a distribution which, if the Company is a C corporation, could be treated as a dividend.

36. As noted in footnote 5, stock purchased from a stockholder and not from the issuing corporation cannot be "qualified small business stock" eligible for the benefits of Section 1202 in the hands of the purchaser (and redemptions can prevent stock purchased from the issuing corporation from being qualified small business stock).

37. If the Company is an S corporation and the purchase is of least 80% (by vote and value) of the outstanding stock of the Company, the purchaser and the stockholders of the Company could step up the tax bases of the Company's assets by electing to treat the purchase as an asset purchase for tax purposes under Section 338(h)(10) or Section 336(e) of the Code. If less than 100% of the outstanding stock of the Company is being sold, however, the election would nevertheless trigger all of the gain inherent in the Company's assets.

38. If the purchases from the existing owners are structured as redemptions, the existing owners may similarly have ordinary income to report under Code Sections 736 and 751(b) to the extent that they receive cash other than for interests in Company property or for their interests in any "unrealized receivables" or substantially appreciated "inventory" of the Company.

39. It is worth noting that the rules for purchasing an interest in a partnership with a Section 754 election in effect can be more favorable than the rules for purchasing stock of an S corporation with a Section 338(h)(10) or Section 336(e) election in effect in that (i) there is no 80% minimum purchase requirement for basis adjustments to be available as a result of a Section 754 election and (ii) if the purchase is of less than 100% of the outstanding interests, the Section 754 election does not require the recognition of all of the gain inherent in the entity's assets.

40. If the Company is a corporation and the purchaser is a C corporation, the stock of the purchaser received by a Company owner cannot be "qualified small business stock" because qualified small business stock may not be issued for stock.

41. A contemporaneous contribution by any existing stockholder of the purchaser must satisfy a "de minimis" requirement for the holdings of the existing stockholder to count.

42. In general, subject to certain limitations, the purchaser takes a basis in the Company equity it receives from the Company owner equal to the Company owner's adjusted basis in the Company equity plus the gain recognized by the Company owner.

43. As noted in Section I.b.1. above, the acquisition of all of the outstanding equity interests in an entity classified as a partnership for tax purposes is treated, from the purchaser's standpoint, as an asset purchase.

44. Section 721 is the "partnership" counterpart of Code Section 351 but, among other things, lacks the 80% post-exchange "control" requirement of Section 351. Code Section 752 (and ancillary provisions) can apply as well (to cause deemed distributions and contributions) if the partnership assumes debt of the Company owners in connection with the transfer.

45. Thus, for example, if a Company owner transfers his or her Company equity to an LLC classified as a partnership for $80x of cash and an interest in the LLC worth $20x, the owner has sold 80% of his Company equity (with an adjusted basis of 80% of his total equity) for $80x under Code Section 707 and contributed his or remaining Company equity to the LLC for the LLC interest worth $20x under Code Section 721. It is worth noting that this analysis is different from the analysis that applies if the transfer is to a corporation for cash and stock of the corporation under Code Section 351.

46. Code Section 197(f)(9) may prevent the purchaser's amortization of any goodwill, going concern value or certain similar assets acquired from the Company if (i) the assets were held or used by the Company before the enactment of Code Section 197 and (ii) the Company or its owners will hold more than 20% of the outstanding equity of the purchaser.

47. Less income and gain for the Company and its owners usually translates into less basis for the purchaser in the Company's assets, but that may be a fair compromise (and a more palatable alternative for the Company's owners than, for example if the Company is an S corporation, a transfer of less than 100% of the shares of the Company with a Section 338(h)(10) or Section 336(e) election).

48. Particularly if the Company is an S corporation, matters may become more complicated if the Company's owners will not share in the equity and cash the Company receives for its assets in proportion to their interests in the Company.

49. See Rev. Rul. 68-55, 1968-1 CB 140.

50. Code Section 752 (and ancillary provisions) can apply as well if the partnership assumes debt of the Company in connection with the transfer.

51. It should be noted that, depending on the circumstances, transactions with rollover features (including transactions that are not bifurcated as described in this section) may present "step transaction" issues.

52. If the stock of the corporation is held outside of the partnership prior to the transaction and is "qualified small business stock" eligible for the benefits of Code Section 1202, a contribution of the stock to the partnership will cause the stock to cease to be qualified small business stock.

53. See Code Section 424(c), however, for an exception to the term "disposition" for purposes of the incentive stock option ("ISO") "disqualify