Minimizing the IRS as Your Unwanted Partner

Tax aspects of merger and acquisition transactions

By Thomas M. Edens

One of the most significant uses of proceeds resulting from the sale of a business is the payment of the toll charge extracted by the Internal Revenue Service. Therefore, a summary knowledge of the relevant tax laws governing merger and acquisition transactions and the advice of an expert tax counselor are critical to minimizing the amount of tax owed.

The first section of this article will address recent tax law changes that have a potential significant effect on sales of closely held businesses—most namely installment sales. The remainder of the article will describe the most common tax attributes that are encountered in merger and acquisition transactions.

Installment sales

In December 1999, the Tax Relief Extension Act of 1999, was passed into law and included a provision that eliminated installment sale treatment for accrual basis taxpayers. This tax legislation will potentially have a significant negative impact on business sales and dispositions. In the past, a taxpayer could defer the portion of the tax liability applicable to amounts received in installments, usually from notes received by the buyer. This allowed an appropriate matching of installment payments with corresponding tax liabilities on those payments.

As of Dec. 17, 1999, accrual basis taxpayers must pay the tax now on the future installment receipts. Cash basis taxpayers may still utilize the deferral benefits of the installment sale treatment. Excluded from the Act are transactions that are structured as "Stock Sales" versus "Asset Sales." This assumes that most individual taxpayers are cash basis taxpayers. Generally, corporations with greater than $5 million of revenues are accrual basis taxpayers and, therefore, not eligible for installment sale treatment.

The effect of this Act is that it places considerable pressure on owners of small companies to require a larger cash payment up-front, which could result in a reduction in the total purchase price as buyers meet their return on cash investment criteria. Accrual basis taxpayers selling their companies with a low down payment and a significant installment note could be faced with a large cash tax payment in the first year of the sale, which could cause the transaction to fail before it closes.

Small business advocacy groups are currently lobbying Congress to correct the unintended effects of the Act. A repeal is predicted and could be retroactive to the effective date. However, a repeal is not likely in 2000.

Taxable asset versus stock sales

Generally, most M&A transactions will either be structured as an "asset" sale or a "stock" sale. In an "asset" sale, the company is selling certain assets and specific liabilities to the acquirer. The assets and liabilities that are not sold and are retained by the selling corporation will be disposed of as desired by the shareholders. "Stock" sales are structured whereby the shareholders are selling the shares of stock of the corporation to the acquirer. Certain assets may be transferred out of the corporation or redeemed by the selling shareholders immediately prior to a sale, but care should be exercised as this may cause adverse tax consequences.

Generally, stock sales are preferable to "C" corporation shareholders because the taxable gain is taxed only once at the shareholder level and at capital gains rates (currently at 20 percent—excluding state tax considerations). Stock sales are also an easier transfer of the business because sellers are transferring title to stock certificates rather than by transferring title to each asset in a corporation. Additionally, client,

vendor or lease agreements or licensing issues may facilitate or require a transfer by a stock transaction versus disturbing existing contracts with the corporation.

Acquirers, on the other hand, usually prefer asset sales for a number of reasons. By purchasing assets versus stock, an acquirer can step-up the basis in the assets acquired to their far market value and depreciate the assets over prescribed amortization periods. All things remaining equal, the acquirer cannot afford to pay as much utilizing a stock sale because of the loss of tax deductions after a sale resulting from his new basis in the stock not being amortizable. Secondly, by acquiring assets, an acquirer has less risk management issues to contend with such as contingent (or undisclosed) liabilities of the corporation that could potentially be inherited. Asset sales usually result in a lesser degree of due diligence efforts by the acquirer and less stringent representations and warranties in the definitive purchase agreement. Another benefit of asset sales is that the acquirer can easily change the state of incorporation.

"C" corporation transactions

As previously mentioned, "C" corporation (or regular corporation) shareholders will typically prefer to sell stock versus assets. Stock sales will, generally, create a capital gains tax liability to the shareholders in an amount equal to the amount received less the shareholders' basis in the stock. Assuming the holding period of the stock has exceeded one year, the capital gain rate is currently at 20 percent (exclusive of state tax implications). The acquirer will assume the seller's basis in the underlying assets of the corporation and the acquirers' acquisition cost for the stock becomes a non-amortizable asset. For companies that are publicly held or have aspirations to go public, a stock sale could be problematic for two reasons:

1. The economic issue of owning a large asset that cannot be written off for tax purposes.
2. The negative impact on earnings per share resulting from a higher than statutory tax rate resulting from the deferred taxes recorded due to the amortization of the acquisition for book purposes and not for tax purposes.

"C" corporation "asset" sales are extremely tax inefficient for the selling shareholders. The sellers are paying taxes at both the corporate level and the shareholder level. When the assets are sold, the corporation must pay taxes on the purchase price in excess of the underlying tax basis in the assets sold. Usually, amounts allocated to the tangible assets (equipment) in excess of basis are taxed at ordinary income rates for corporations (current maximum at 35 percent). The majority of the purchase price applicable to the assets of service businesses is allocated to goodwill. The corporation will be taxed for the goodwill allocation at capital gains rates for corporations, which is currently the same as regular corporate tax rates of 35 percent. "C" corporation "asset" sales could result in a combined federal and state income tax rate that approaches 50 percent of the purchase price as the transaction is taxed on both the corporate level and shareholder level.

"S" corporation transactions

"S" corporations selling stock are taxed similar to "C" corporations in that the selling shareholders are taxed at capital gains rates for the amount of purchase price less the basis in stock.

If an "S" corporation sells assets, the shareholders usually incur one level of tax as compared to "C" corporation shareholders incurring tax at both the corporate level and the shareholder level. "S" shareholders selling a service business will incur primarily capital gains taxes on the goodwill portion of the purchase price allocation and a combination of ordinary income tax and capital gains tax rate on the amount allocated to equipment. Amounts allocated to accounts receivable are taxed at ordinary income tax rates. Also, as indicated above, accrual basis "S" corporations with cash basis shareholders result in installment notes being taxable at time of sale when utilizing an asset sale.

"S" corporations that were formerly "C" corporations and made the "S" election after 1986 may incur a "built-in gains" tax. Generally, this tax (equivalent to the maximum corporate tax rate, currently at 35 percent), is applicable for "S" corporations making the conversion within 10 years prior to a sale of the business. Under this tax, an "S" corporation is subject to corporate level tax (and later to tax on a shareholder level) on the net appreciation of any assets it formerly held as a "C," including goodwill. Ideally, a valuation was performed as of the date of the "S" conversion and will allow the shareholders to determine the amount of the built-in gains tax.

Other considerations commonly incurred by "S" corporations contemplating asset sales are state tax considerations. State income or franchise taxes on asset sales are usually more onerous than respective stock sales, all other aspects of the transaction remaining equal.

Shareholders should be aware of the IRS code section 338(h)(10), which is often advanced by acquirers whenever a transaction is proposed to be structured as a "stock" sale. This code section will have the effect of treating the transaction as an asset sale for tax purposes while retaining the legal transaction attributes as a "stock" sale. This code section may trigger adverse state tax consequences, impair installment tax treatment or cause ordinary income tax recapture on certain assets of the corporation. This complex code section requires guidance from a seasoned transactional tax advisor.

Tax elections and allocations

Table A illustrates the various tax attributes of purchase price allocations most commonly encountered in asset sales.

The amounts applicable to the allocation of purchase price are required to be agreed upon by both the buyer and seller and memorialized on IRS Form 8594. The seller must make the allocation to determine the amount and character of gains or losses, and the buyer is required to determine future allowable depreciation and amortization.

In the not too distant past, buyers were

aggressively allocating purchase price proceeds to the covenant not to compete agreement and amortizing the cost over the term of the agreement—usually ranging from three to seven years. However, since 1993, acquirers must amortize non-compete agreements over 15 years (the same amortization period as goodwill which became eligible for amortization in 1993). The acquirers are still able to deduct the payments made pursuant to consulting agreements when paid. Therefore, acquirers typically favor allocating more dollars to consulting agreements. The impact to sellers is that consulting agreement payments are an expensive currency because of ordinary income rates applicable to the payments plus self-employment taxes incurred on the same amounts.

A 1998 IRS case is currently being monitored for the implications on allocations of purchase price. The case was the *Martin Ice Cream Company vs. Commissioner of Internal Revenue* and resulted in a portion of the purchase price being allocated to "Personal Goodwill." This had the effect of a substantial allocation of purchase price away from the "C" corporation asset sales and allowed the shareholder to utilize capital gains rates thereby avoiding double taxation. The buyer benefited from a 15-year write-off of the intangible (goodwill). This allocation was separate from the covenant not to compete allocation, which was a substantially lesser amount. This case may result in the common use of this advantageous allocation—especially to service businesses where the shareholder has demonstrably valuable relationships with clients. This case is currently being considered for appeal to the Third Circuit Court of Appeals.

Tax planning

There are several tax planning initiatives that can be undertaken by business owners prior to a sale. This involves planning the proper timing and exit strategies for a company. If the corporation is a "C" corporation and the shareholders have a long-term time horizon before a planned sale, or there is an expected significant increase in the value of the business over the near-term, one should consult their tax advisor about the feasibility of converting the company to an "S" corporation. The "S" corporation provides the most flexibility in structuring a stock, asset or stock-for-stock sale. Other legal entities (especially flow-through entities) can offer favorable tax treatment upon a sale, but conversion to such format should take place well before a sale is initiated.

Any planned gifts to heirs or promised transfers of stock to key employees should be accomplished and legally documented long before negotiations are undertaken with potential buyers. Otherwise, stock transfers and the immediate subsequent sales to acquirers will typically result in ordinary income treatment to the stock recipient versus capital gains if proper planning was utilized.

If charitable contributions of company interest (through a charitable remainder trust, or otherwise) or other planned giving techniques are utilized, it is of utmost importance to plan early. Documentation of any of these options can take a considerable amount of time.

It is generally advisable to avoid contributing assets to a corporation that have a likelihood of appreciating significantly such as real estate or intangibles.

TABLE A

Purchase Price Allocation	Seller Taxation (d)	Acquirer Deduction	Generally, More Favorable To
Equipment (a)	Capital Gains, probable depreciation recapture taxes at ordinary income rates	3 to 7 years	Acquirer
Goodwill (a)	Capital Gains	15 years	Seller or neutral
Land (a)	Capital Gains	When sold	Seller
Building (a)	Capital Gains except for any depreciation recapture	39 years	Seller
Non-compete	Ordinary Income when received	15 years (b)	Acquirer
Consulting Agreement	Ordinary Income when received (c)	When paid	Acquirer

(a) For "C" corporation "asset" sales, these amounts are ultimately taxed twice as compared to "S" corporations being taxed only once.
(b) Acquirers are required to amortize non-compete payments over 15 years regardless of the length of the term of the noncompete contract.
(c) Sellers will have self-employment tax liabilities of 15.3 percent due on consulting agreement receipts.
(d) For "C" corporation sellers, capital gain rates are the same as ordinary income tax rates.

Summary

This article is not intended to give tax advice, but to expose business owners to the more significant tax issues that are common in business sale transactions. It cannot be emphasized too strongly the importance of retaining the expertise of a skilled tax professional as a key member of your transaction team when selling your business (or acquiring one yourself). CM

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