



# Tax Considerations in Buying or Selling a Business

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The after-tax consequences of buying or selling a business can vary dramatically depending on how the transaction is structured. Often, what's good for one party is bad for the other. The structure of the transaction, therefore, can be driven by the relative bargaining positions of the parties and, in any event, should be taken into account in determining the price. The consequences of the transaction to employees and other service providers should be considered as well.

I. Taxable Transaction.

As described below, the owners of a business can sell the business "tax-free" if the business is organized as a corporation and the price to the owners is paid in the form of stock of an acquiring corporation. Otherwise, the sale of the business generally will be taxable to the owners. If the transaction will be taxable, the tax consequences will depend primarily on whether the buyer (the "Acquiror") purchases (i) the equity interests of the owners in the business or (ii) the assets of the business. Thus, if the business being purchased (the "Target") is organized as a corporation, the parties may structure the transaction as a purchase and sale of either the stock in the Target or the assets of the Target.

a. Stock Purchase.

If the Target is a corporation, the shareholders of the Target will generally prefer to structure the transaction as a purchase and sale of their stock in the Target. That way, the gain on the transaction is taxed only once (at the shareholder level) and at capital gain rates. The Acquiror, on the other hand, may not want to purchase stock because, except as described below under "Stock Purchase Treated as Asset Purchase," a stock purchase has no effect on the tax bases of the Target's assets. Instead, the Acquiror takes a basis in the stock purchased equal to the amount it pays for the stock (and the taxable income inherent in Target's assets remains inherent in the assets). Stock is not amortizable.

- The Target shareholders may also prefer a stock sale from a non-tax standpoint because the Acquiror assumes the economic burden of any Target liabilities except to the extent that the Target shareholders agree to remain responsible.
- A stock purchase may be effected by a direct purchase of the Target's stock or by a "reverse subsidiary merger."<sup>1</sup> In a reverse subsidiary merger, the Acquiror forms a transitory subsidiary, capitalizes the transitory subsidiary with the cash or other assets to be used as the purchase price (including any borrowed money if the purchase will be leveraged), and then merges the transitory subsidiary into the Target. When the dust settles, the Target shareholders have the cash or other assets used as the purchase price, and the Target is a subsidiary of the Acquiror.

- If the Target stock is “qualified small business stock,” individual Target shareholders who have held their shares for more than five years may be able to exclude up to 50% of their gains.
- Some or all of the gain, however, may be taxable at ordinary income rates if the Target is a partnership or LLC.<sup>ii</sup> In addition, if the Target is not a C corporation and owns “collectibles,” a portion of the gain may be taxable at a higher capital gain rate than would otherwise apply.
- A stock sale may also be desirable if the Target has assets (such as non-assignable contract rights) that would be difficult to transfer.

b. Asset Purchase.

If the Target is a corporation, the Acquiror generally prefers (at least for tax purposes) to structure the transaction as a purchase and sale of the Target’s assets so that the Acquiror may “write up” the tax bases of the assets. By writing up the bases of the purchased assets, the Acquiror can report greater depreciation and amortization deductions with respect to, and smaller amounts of gain (or greater amounts of loss subject to any applicable limitations) upon re-sales of, the purchased assets. The Target shareholders, on the other hand, may not want to structure the transaction as an asset sale because (i) if the Target is a C corporation (or an S corporation with assets acquired while it, or any corporation it acquired in a tax-free transaction, was a C corporation), the gain on the sale may be taxable to both the Target and the Target shareholders, and (ii) if the Target is an S corporation, some or all of the gain may be reportable by the shareholders as ordinary income (depending on the Target’s assets and the allocation of the purchase price).

- The Acquiror may also prefer an asset purchase from a non-tax standpoint so that the economic burden of the Target’s liabilities remains with the Target’s shareholders.
- In an asset purchase, the Target is treated as selling, and the Acquiror is treated as buying, the various Target assets separately for allocable portions of the aggregate purchase price. The aggregate purchase price is allocated among the various Target assets in accordance with certain tax rules (essentially, by class and fair market value). Particularly if the Target is an S corporation, partnership or LLC, the Target will prefer to allocate the purchase price so as to maximize the amount of long-term capital gain to be reported on the sale. The Acquiror, on the other hand, will likely want to allocate as much purchase price as possible to purchased receivables (and other assets likely to turn over in the short term) and assets with short depreciation or amortization schedules.

- If the Target is a partnership or LLC, the mix to the owners of capital gain and ordinary income will depend on the Target's assets and the allocation of the purchase price.

c. Stock Purchase Treated as Asset Purchase.

Under certain circumstances, a purchase of the equity interests in the Target may generate the same tax results as a purchase of the Target's assets.

- If the Acquiror is a corporation and the Target is an S corporation or a subsidiary of another corporation, the Acquiror and the Target shareholders may join in making a special tax election to treat a purchase and sale of the stock of the Target as a purchase and sale of the Target's assets.
- If the Target is a partnership or LLC that either has a special tax election in effect or is wholly owned by the Acquiror after the transaction, the Acquiror will be able to write-up the basis (or, if it acquires less than all of the interests in the Target, its share of the basis) of each of the Target's assets.

II. Tax-Free Transaction.

If the Acquiror and the Target are corporations, the transaction may be "tax-free" entirely or in part to the Target shareholders if it qualifies as a "reorganization." In that case, the Target shareholders generally report their gains only to the extent of any of their purchase price that is not paid in the form of stock of the Acquiror (or the Acquiror's parent corporation). Any gain they avoid reporting remains inherent in the Acquiror stock they receive in the transaction. The Acquiror writes up the tax bases of the Target's assets only to the extent of any gain reported by the Target.<sup>iii</sup>

- 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 Target be paid in the form of qualifying stock of the Acquiror (or its parent). The minimum percentage ranges from 50% (or even lower under judicial authorities) 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).
- If the Target stock is "qualified small business stock," the stock of the Acquiror (or its parent) received by a Target shareholder in the reorganization is also treated as qualified small business stock (if it otherwise would not have been) received by the Target shareholder on the date he acquired his Target 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 Acquiror (or its parent) by the Target shareholder, however, is limited to the amount of gain built into the Target stock as of the time of the exchange of the Target stock for the Acquiror stock.

### III. Deferred or Contingent Payments; Holdbacks and Escrows.

It is not uncommon for a portion of the purchase price to be paid over time or as certain performance goals are met (the deferred payment obligation may be evidenced by a note or by the purchase and sale agreement). In addition, a portion of the purchase price may be held back or placed into escrow to secure obligations of the Target or its shareholders to indemnify the Acquiror for breaches of representations, warranties and covenants.

#### a. Original Issue Discount.

If adequate interest on a deferred portion of the purchase price is not payable periodically, the tax rules will recharacterize part of the deferred amount as interest. In addition, with respect to any non-contingent deferred amounts due, the interest is reported as it economically accrues on the basis of a constant yield to maturity rather than when it is actually paid (so that the Target or its shareholders may have to report interest income for a year in which they receive no payments).

#### b. Installment Method.

Generally, a taxpayer's gain on a deferred payment sale is reported under the installment method unless the taxpayer elects not to use the method. Under the installment method, the taxpayer computes the percentage which his overall profit on the transaction represents of the overall amount he will receive in the transaction. He then multiplies each "payment" he receives by that percentage to determine the portion of the payment that is gain. Payments of interest (including amounts recharacterized as interest) are disregarded in applying the installment sale rules.

- The contingent payment provisions of the installment sale rules make some unfriendly assumptions (including that the full amount of any capped contingent payments will be received). Accordingly, they may distort the reporting of the gain on the sale.
- Care must be taken to ensure that escrow and other security arrangements do not result in deemed "payments" to the Target or its shareholders.
- Recapture and gains from sales of inventory and publicly traded stock are not eligible for reporting under the installment method.
- A taxpayer 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.
- If the Target is an S corporation (or a consolidated subsidiary) and the Target's shareholders sell their stock but join in making a special election

to treat the sale as an asset sale, the applicability of the installment method may be limited.

- If the Target is an S corporation and will distribute an installment obligation received from the Acquiror to its shareholders in liquidation, it may be advisable to structure the sale and liquidation so that the installment obligation is not distributed along with other assets.

c. “Tax-free” Reorganization.

If the transaction is intended to qualify as a “tax-free” reorganization, care must be taken to ensure that the arrangement does not jeopardize that qualification.

IV. Outstanding Options and Restricted Stock.

Often, employees and other service providers of the Target have Target options or shares of restricted Target stock. The consequences of their participation in the purchase and sale transaction can vary significantly depending on the circumstances.<sup>iv</sup>

a. ISOs.

The tax consequences of the transaction to a holder of an incentive stock option (“ISO”) of Target will depend on what the holder receives for the option.

- The holder of a Target ISO is generally not taxable on his exchange of the ISO for a new option of Acquiror unless (i) the value of the stock underlying the new option exceeds the exercise price of the new option (that is, the new option is “in the money”) when he receives the new option and (ii) the new option fails to qualify for treatment as an ISO.<sup>v</sup>
- For the new option to qualify as an ISO, (i) with certain exceptions, the terms of the new option must not be more favorable to the optionholder than those of the old option, (ii) the spread (the amount by which the value of the underlying stock exceeds the exercise price) on the new option as of the time immediately after the exchange must not be greater than the spread on the old option as of the time immediately before the exchange, and (iii) the value of the shares subject to the new option as of the time immediately after the exchange must not be greater than the value of the shares subject to the old option as of the time immediately before the exchange.
- If the holder receives cash or stock for the option, he reports the amount of cash and the value of any stock he receives (less any amount he pays to exercise the option) as ordinary income (unless he receives the stock in a “tax-free” reorganization in exchange for stock of the Target acquired by

exercising the option).<sup>vi</sup> If any new stock received by the holder is restricted upon receipt, however, the income with respect to that stock is deferred until the restrictions lapse (at which time the income is determined with reference to the then value of the stock) unless the holder makes a timely Section 83(b) election with respect to the stock.

- If the holder exercises the option for stock of the Target and then exchanges the Target stock for stock of the Acquiror in a “tax-free” reorganization, the holder has only a potential alternative minimum tax liability based on the spread at the time of exercise if he holds the stock of the Acquiror for at least a year after exercising the option (and for at least two years after being granted the option).

b. NQSOs.

Like the consequences to a holder of a Target ISO, the tax consequences of the transaction to a holder of a non-qualified stock option (“NQSO”) of Target depend on what the holder receives for the option.<sup>vii</sup>

- The holder is generally not taxable on his exchange of the Target NQSO for a new Acquiror option unless (i) the Acquiror option is in the money upon its grant to the holder and (ii) the Acquiror option fails to satisfy the substitution test that would be applicable in determining its qualification as an ISO if the Target NQSO were an ISO (with the spread requirement being satisfied if the ratio of the exercise price of the Acquiror option to the fair market value of the underlying Acquiror shares as of the time immediately after the exchange is not greater than the ratio of the exercise price of the Target NQSO to the fair market value of the underlying Target shares as of the time immediately before the exchange).<sup>viii</sup>
- If the holder receives cash or stock for the option, he reports the amount of cash and the value of any stock he receives (less any amount he pays to exercise the option) as ordinary income.<sup>ix</sup> If any new stock received by the holder is restricted upon receipt, however, the income with respect to that stock is deferred until the restrictions lapse (at which time the income is determined with reference to the then value of the stock) unless the holder makes a timely Section 83(b) election with respect to the stock.

c. Restricted Stock.

The consequences of the transaction to a holder of restricted Target stock will likely depend on whether or not the holder made a timely Section 83(b) election with respect to the Target stock.

- If the holder did not make a timely Section 83(b) election with respect to the restricted Target stock, he reports ordinary income on the transaction

equal to (i) the amount of cash and the value of any stock he receives for the restricted Target stock less (ii) the amount he paid for the restricted Target stock. If any new stock received by the holder is itself restricted upon receipt, however, the income with respect to that stock is deferred until the restrictions lapse (at which time the income is determined with reference to the then value of the stock) unless the holder makes a timely Section 83(b) election with respect to the stock.

- If the holder made a timely Section 83(b) election with respect to the restricted Target stock, he generally reports capital gain equal to (i) the amount of cash and the value of any stock he receives for the restricted stock less (ii) the amount he paid for the restricted Target stock plus the amount of any income he reported upon his receipt of the restricted Target stock. If, however, the transaction is a “tax-free” reorganization, the holder reports gain on the transaction only to the extent of any purchase price he receives other than in the form of stock of the Acquiror (or the Acquiror’s parent corporation).

d. Golden Parachute Issues.

Special rules apply 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 shareholder of the corporation or is among the highest paid 1% or, if less, 250 employees of the corporation. An individual’s “base amount” is his 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.

- The acceleration of the vesting of Target options or restricted stock can give rise to parachute issues. Often, however, the amount that must be taken into account as a payment contingent on the change of control of the Target is limited to the time value of the acceleration (plus an amount reflecting the lapse of the obligation to continue performing services).
- If the Target is a private company, the applicability of the parachute rules can be avoided by subjecting what would otherwise be parachute payments to approval by the Target’s shareholders. 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.



