SELLING A BUSINESS – THE TAX ISSUES

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1. PRE-SALE PLANNING

1.1 There are opportunities for gifts to family members and donations to charity.

1.1(a) GRATs for children and charitable remainder trusts are examples.

1.2 The time to complete these is *before* a letter of intent is signed.[1]

1.3 If the sale does not occur, the "pre-sale" transactions can't be unwound.

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[1] Court Holding Company v. Comm'r, 324 US 331 (1945); Ferguson v Comm'r, 174 F.3d 997 (9th 1999) ("The key issue here is whether the Fergusons had completed their contributions of the appreciated AHC stock before it had ripened from an interest in a viable corporation into a fixed right to receive cash. ... [There is no clear line demarcating the first date upon which a taxpayer's appreciated stock has ripened into a fixed right to receive cash pursuant to a pending merger. However, from the perspective of taxpayers, walking the line between tax evasion and tax avoidance seems to be a patently dangerous business. Any tax lawyer worth his fees would not have recommended that a donor make a gift of appreciated stock this close to an ongoing tender offer and a pending merger, especially when they were negotiated and planned by the donor."). *But see* Rauenhorst v. Comm'r, 119 T.C. 157 (2002) (refusing to allow the IRS to argue against the bright line standard that it adopted in Rev. Rul. 78-197, 1978-1 C.B. 83, for transfers to charities of shares that were later redeemed).

2. ASSET SALES BY C CORPORATIONS

2.1 Double tax on sale of C corporation assets:

2.1(a) A C corporation pays tax on the "inside" gain.[2]

2.1(b) When the C corporation distribute the after-tax sale proceeds to its shareholders:

- ◊ If the C corporation liquidates, the shareholders will pay a second tax on the "outside" gain (usually at long-term capital gain rates), applying their basis in their shares.[3]

- ◊ If the C corporation does not liquidate, the shareholders receive a qualified dividend at favorable tax rates, but cannot apply their basis in the shares.[4]

- ◊ The 3.8% net investment income tax ("NIIT") will apply if the shareholder's income exceeds the threshold, whether or not the shareholder is active in the C corporation's business.[5]

2.2 Use the Section 1060 "residual" method of allocating the purchase price to the various assets sold.

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2 I.R.C. § 11.

3 I.R.C. §§ 1(h)(1), 331, 1001.

4 I.R.C. §§ 1(h)(11), 301.

5 I.R.C. § 1411.

2.3 Cash method sellers will recognize gain on the sale of accounts receivable (because the seller has no basis in them).

2.4 A manufacturers will recognize gain on work in process and finished goods (to the extent that the price paid for it exceeds the cost of the materials). A distributor will rarely have gain in its inventory (because the price paid will rarely exceed the cost).

2.4(a) The seller will need to get the buyer's resale certificate to avoid sales tax on the sale of inventory.[6]

2.5 Sales tax applies to sales of tangible assets not held for resale.[7] Examples: furniture, computers, equipment, vehicles.

2.5(a) Occasional sale rule might apply.[8]

2.5(b) Consider putting the tangible assets in a single-member LLC before going to market, and selling the LLC interest instead of the hard assets.[9]

2.6 Liabilities assumed by the buyer increases the seller's "amount received" for computing gain.[10]

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[6] Cal. Rev. & Tax. Code § 6421; Cal. Code Regs. Title 18, § 1667(a).

[7] Cal. Rev. & Tax. Code § 6051; Cal. Code Regs. Title 18, § 1668(a).

[8] Cal. Rev. & Tax. Code §§ 6006.5(a), 6367; Cal. Code Regs. Title 18, § 1595(a).

[9] Cal. Gov. Code § 50026.5 (prohibiting state or local tax on stocks, bonds or other securities). Note that a membership interest in an LLC is personal property (Cal. Corp. Code §§ 17701.02(aa), 17705.01), but it its not tangible personal property that can be subject to the sales tax. Cal. Rev. & Tax. Code § 6051 (imposing sales tax on sales of tangible personal property).

2.7 Limits on installment sales[11]

2.7(a) Including depreciation recapture[12]

2.7(b) If a C corporation distributes an installment note, the deferred gain will be recognized.[13]

2.8 IRS Form 8594 should be filed by buyer and seller.[14]

2.9 Why buyers generally prefer assets sales to stock deals:

2.9(a) Buyer can organize a new entity with no tax or operating history.

2.9(b) Buyer can depreciate hard assets not held for resale over the remaining useful life (and so an incentive to allocate as much as possible to these assets, exacerbating the sales tax problem)[15]

(footnote continued from previous page)

[10] I.R.C. § 1001(b); Treas. Reg. § 1.1001-2(a)(1).

[11] I.R.C. §§ 453(b)(2) (sales by dealers, sales of inventory), 453A(a) (interest charge on deferred gain), (d) (pledges of installment obligations), 691(a)(4) (deferred gain is income in respect of a decedent), 1014(c) (no basis adjustment at death for IRD), 1374(d)(7)(B) (S corp can't use installment sale to defer gain past the built-in gain "recognition period").

[12] I.R.C. § 453(i).

[13] I.R.C. § 453B(a)(2).

[14] I.R.C. § 1060; Treas. Reg. § 1.1060-1(e).

[15] I.R.C. § 167.

2.9(c) Buyer can amortize goodwill and other intangibles over 15 years[16]

◊ Buyer amortizes payments for covenant not to compete over 15 years, whether in an asset sale or stock sale.[17]

3. ASSET SALES BY S CORPORATIONS

3.1 No double tax, except for assets subject to the built-in gain tax[18]

3.1(a) Note that the "recognition period" for built-in gain is now 5 years for federal tax purposes and still 10 years for California tax purposes[19]

3.2 Gain on cash method accounts receivable, manufacturer's inventory and depreciation recapture is taxed at ordinary income rates[20]

3.3 Sales tax on tangible assets not held for resale (see notes above for asset sales by C corps)[21]

3.4 Assumption of liabilities increases "amount received" for computing gain[22]

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16 I.R.C. §197(a), (d)(1)(A).

17 I.R.C. §197(a), (d)(1)(E); Treas. Reg. § 1.197(f)(3)(i).

18 I.R.C. §§ 1363(a), 1366, 1374.

19 I.R.C. § 1374(d)(7)(A); Cal. Rev. & Tax. Code §§ 17024.5(a)(1)(O), 23051, 23809.

20 I.R.C. §§ 1221(a), 1231, 1366(b) (character of flow-through items).

21 See Section 2.5 above.

3.5 Limits on installment sales

3.5(a) Including depreciation recapture, which is taxed at ordinary income rate to the shareholders[23]

3.5(b) An S corporation can distribute an installment note without triggering recognition of the deferred gain.[24]

3.6 Same benefits to buyer as in an asset sale by a C corporation[25]

4. "STRAIGHT" SALE OF S OR C CORPORATION STOCK (WITH NO SECTION 336 OR 338 ELECTION)

4.1 All gain is taxed at long-term capital gain rates (if the stock was held for more than a year)[26]

4.2 No ordinary income from depreciation recapture (because "entity approach" to sale of S corporation stock)

4.2(a) No concept of "hot assets" in the sale of S corporation stock.[27]

(footnote continued from previous page)

[22] See Section 2.6 above.

[23] See Sections 2.7(a) and 3.2 above.

[24] I.R.C. §§ 453(h), 453B(h); *see* J. Eustice, J. Kuntz & J. Bogdanski: FEDERAL INCOME TAXATION OF S CORPORATIONS (WG&L) ¶ 13.04[7][a][i] (2017).

[25] See Section 2.9 above.

[26] I.R.C. § 1(h), 1221(a), 1222,

4.3 The corporation's liabilities do not affect how the purchase price is taxed

4.4 Detriments to buyer

4.4(a) Buyer takes a "used" entity with a tax and operating history

4.4(b) Buyer cannot depreciate or amortize the purchase price for the shares

◊ Buyer amortizes payments for covenant not to compete over 15 years, whether in an asset sale or stock sale.[28]

5. SECTION 336(E) OR 338(H)(10) ELECTION FOR THE SALE OF S CORPORATION STOCK

5.1 A sale of stock for corporate law purposes

5.1(a) So no sales tax (because it's not a sale of tangible personal property)

5.2 A sale of assets for tax purposes[29]

(footnote continued from previous page)

[27] Compare the Section 751(a) rule for partnerships. But if the corporation holds appreciated collectibles, the tax rate can be increased. I.R.C. § 1(h)(5)(B); Treas. Reg. § 1.1(h)-1.

[28] I.R.C. § 197.

[29] I.R.C. §§ 336(e), 338(a).

5.2(a) So "assumed" liabilities will affect the seller's "sale price" for tax purposes[30]

5.2(b) And depreciation recapture will be taxed to the seller as ordinary income[31]

5.2(c) Installment method can apply, but the analysis must include the Section 338 regs[32]

5.3 Same benefits to buyer as an asset sale, except the buyer takes a "used" entity with its own history

5.4 To use Section 338(h)(10), the buyer must be a corporation[33]

5.4(a) The buyer has a tax filing obligation that the seller(s) must sign.[34]

5.5 To use 336(e), the buyer(s) can be one or more individuals, partnerships or LLCs.[35]

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30 Treas. Reg. § 1.338-4(b)(1).

31 Treas. Reg. § 1.338(h)(10)-1(d)(5)(i).

32 Treas. Reg. § 1.338(h)(10)-1(d)(8).

33 I.R.C. § 338(d)(3).

34 Treas. Reg. § 1.338(h)(10)-1(c)(3) (Form 8023).

35 Treas. Reg. § 1.336-2(a).

6. SALE OF STOCK OF C CORPORATION

6.1 Section 1202 exclusion

6.1(a) It is possible to avoid the "outside" tax on the sale of C corporation shares if the sale meets the requirements of Section 1202.

6.1(b) Gain on the sale or exchange of qualified small business stock is excluded from both regular tax and the alternative minimum tax.

6.1(c) Up to $10 million in gain can be excluded for a single corporation.

6.1(d) As a consequence, in a stock sale there would be no gain to the seller.

- ◊ *This is the best possible tax outcome in the sale of a business.*

- ◊ In a sale of assets, a distribution of appreciated property or a liquidation, there would be one level of tax – on the "inside" gain.

6.1(e) To qualify for the exclusion:

- ◊ The stock must be held for five years.

- ◊ The issuing corporation must be a domestic C corporation, but not a DISC, a regulated investment company, a REIT, a REMIC or a co-op. (So the shares will not qualify an S corporation converts to a C corporation immediately before the sale.)

- ◊ The shares must be issued by the corporation to the taxpayer.

◊ There are several other requirements for Section 1202 to apply.

6.2 Sale to ESOP

6.2(a) The seller can avoid gain by selling C corporation shares to an ESOP sponsored by the corporation and rolling the sale proceeds into securities of U.S. companies.[36]

6.2(b) The seller takes a carry-over basis in the securities, which could be long-term, non-callable bonds.[37]

6.2(c) The seller can have the immediate benefit of diversification.

6.2(d) The seller can take a margin loan from his broker without triggering gain, with the earnings on the securities offsetting the interest on the margin loan.

6.2(e) If a Section 1014 basis step-up occurs, the seller's family avoids gain entirely.

6.2(f) On the buyer's side, the principal payments on the loan to buy the shares become deductible contributions to the ESOP, with enhanced limits for the amount of deductible contributions.[38]

6.2(g) There are several requirements for this to apply (and more for the ESOP). A feasibility study is the first step.

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36 I.R.C. § 1042(a).

37 I.R.C. § 1042(d).

38 I.R.C. §§ 404(a)(9), 415(c)(6).

7. SALE OF PARTNERSHIP INTEREST

7.1 Ordinary income to the extent that the gain is attributable to hot assets of the target.[39]

7.2 Limits on installment sales

7.2(a) No deferral of gain on hot assets [40]

7.3 Look for sales of 704(c) assets and 707(a)(2)(B) mixing bowls transactions

7.4 Benefit to buyer

7.4(a) Ability to make a Section 754 election to increase the inside basis to reflect the purchase price

◊ Each pretend "new asset" will have its own basis and estimated useful life, and will be deemed to be placed in service at the closing date.[41] The recovery period and for the "old" asset is not affected.[42]

7.5 Detriment to buyer – Buyer takes a "used" entity.

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[39] I.R.C. § 751(a) (rule); Treas. Reg. § 1.751-1(a)(2) (method).

[40] Mingo v Comm'r, 773 F3d 629 (5th 2014); Sorenson v Comm'r, 22 T.C. 321 (1954).

[41] I.R.C. § 743(b); Treas. Reg. § 1.743-1(j)(4).

[42] *Id.*

8. BUSINESS IN AN S CORP BUT BUYER WANTS AN LLC WITH THE SAME EIN

8.1 Create an S corp holding company for the S corporation target

8.2 Make a QSub election for the S corp target (an "F" reorg; no continuity of ownership or enterprise is required in an "F")

8.3 Convert the target corp to an LLC (no tax consequence, since both the QSub and the single-member LLC are disregarded).

8.4 The S corp holding company sells the LLC interest to the buyer

8.5 Same tax consequences to the sellers as a Section 338(h)(10), without the tax filing obligation

8.5(a) But the seller must dispose of the S corporation new holding company.

9. TAX-FREE REORGANIZATIONS

9.1 No tax on the exchange, but a carry-over basis[43]

9.2 Useful for a older seller who wants to avoid income tax and preserve the benefit of a Section 1014 basis step up at death

9.3 Good for an IPO candidate that sputters and can become part of a more promising IPO candidate

9.4 The "seller" should do due diligence on the "buyer"

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[43] I.R.C. §§ 354, 358, 361, 362.

9.5 A "stock-for-stock" "B" reorg requires no boot, so a reverse triangular merger is often used instead.[44]

9.6 Note that LLCs classified as partnerships cannot use the subchapter C reorg rules.

9.6(a) A conversion to a corporation must be old and cold before the converted corporation can use the reorg rules.

10. DISREGARDED ENTITIES

10.1 When an S corporation acquires the stock of target corporation and makes a QSub election for target, the S parent's basis in the *stock* will *disappear* and the target's basis in its *assets* will continue.[45]

10.2 A QSub is not treated as a corporation that can be a party to a reorganization.[46]

10.3 A sale of the shares of a QSub or the interest in a single-member LLC is treated as a sale of assets for income tax purposes (but not for sales tax purposes).[47]

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[44] I.R.C. §368(a)(1)(B), (a)(2)(E). In a "reverse triangular merger" Acquiror organizes a new subsidiary, which merges into Target with Target surviving.

[45] I.R.C. § 334(b); Treas. Reg. § 1.1361-4(a)(2)(i). So getting a step-up in basis in the target assets is an important objective of the buyer.

[46] Treas. Reg. § 1.368-2(b)(1)(i), (iii) *Example 5*.

[47] Treas. Reg. § 1.1361-5(b)(3) *Example 9*. The seller's QSub status terminates, even if the buyer is an S corporation that makes a QSub election for the target corporation (the QSub). Rev. Rul. 2004-85, 2004-2 C.B. 189.

10.4 Converting a QSub to an single-member LLC should have no income tax consequence, because the entity is disregarded before and after the conversion. A single-member LLC becoming a partnership is unlikely to have the catastrophic tax consequences of an inadvertent termination of QSub status.

11. COVENANTS NOT TO COMPETE

11.1 Ordinary income to the seller in the year in which the payment is received[48]

11.2 Amortized by the buyer over 15 years, no matter when paid.[49]

12. EARN-OUTS AND CONTINGENCIES

12.1 Amounts held in escrow for a working capital adjustment for seller's indemnification obligations are generally not treated as paid to the seller until they are released from the escrow to the seller.[50] So a payment from the escrow to the buyer would have no tax consequence to the buyer or the seller.

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[48] Clarence Clark Hamlin Trust v. Comm'r, 209 F.2d 761 (10th Cir. 1954) ("Where a covenant not to compete constitutes a nonseverable element of a transaction in which the owner of a going concern sells the property and transfers the good will of the business, the covenant is to be treated as a contributing element of the assets transferred and the entire revenue received is subject to tax on the basis of a capital gain. [Cites deleted.]. But if a covenant not to compete can be segregated in order to be assured that a separate item has actually been dealt with, then so much as is received for the covenant is ordinary income rather than income from the sale of a capital asset. [Cites deleted.]." It's also not passive income. Treas. Reg. § 1.469-2(c)(7)(iv). See Cal. Code Regs. Title 18, § 17951-6(a) (how much is taxable in California).

[49] Treas. Reg. § 1.197-2(b)(9), (f)(1), (f)(3)(i).

[50] Rev. Rul. 79-91, 1979-1 C.B. 179; Rev. Rul. 77-294, 1977-2 C.B. 173; see PLR 2005-21-007, February 25, 2005.

12.2 An after-closing payment from the buyer to the seller is treated as additional purchase price and, to the extent not allocable to interest or imputed interest, is taxed as ordinary income or capital gain, depending on the source of the payment, using the installment method.[51]

12.2(a) So a typical earn-out payment to the seller would be capital gain.

12.3 A payment from the seller to the buyer after the year in which the closing occurs is generally treated as a capital loss to the seller.[52]

12.3(a) An individual's capital losses can be carried forward *but not back* and have limited value against ordinary income.[53]

13. REAL PROPERTY

13.1 When a buyer acquires California real property or control of an entity that owns the real property, a "change in ownership" will occur, resulting in a reassessment of the property to its current value for property tax purposes.[54]

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[51] Treas. Reg. § 15A.453-1(c)(1).

[52] Arrowsmith v. Comm'r, 344 U.S. 6 (1952).

[53] I.R.C. § 1211(b), 1212(b).

[54] Cal. Rev. & Tax. Code §§ 110.1(a)(2)(A) (effect of change in ownership), 75.18 (when the new base year value is effective), 60 (defining a "change in ownership"), 64(a) (general rule that transferring stock or a partnership interest is not a change in ownership), 64(c)(1) (acquisition of more than a 50% interest is a change of control); *see also* Cal. Code Regs. Title 18, § 462.180(c), (d), (e)(2).

13.1(a) If a subsidiary of the target holds the real property, the acquisition of control of the parent corporation triggers a change of control of the property.[55]

13.1(b) The buyer is obligated to report the change in ownership within 90 days.[56]

13.1(c) If the entity is a partnership or LLC, the change will be reported to the Franchise Tax Board on the entity's California tax return.[57] The FTB reports to the Board of Equalization.[58]

13.2 Section 1250 real recapture can apply, and will be subject to tax at ordinary income rates on the seller's income tax return.

[End of outline.]

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[55] Title Insurance and Trust Co. v. County of Riverside, 48 Cal. 3d 84 (1989),

[56] Cal. Rev. & Tax. Code § 480.1; Form BOE-100-B, Statement of Change in Control and Ownership of Legal Entities. The penalty for failure to file on time is substantial. Cal. Rev. & Tax. Code § 482(b).

[57] FTB Forms 565 and 568.

[58] Cal. Rev. & Tax. Code § 64(e).