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**Transactional Tax Traps for the
Unwary**

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**Presentation to Dallas Bar Association
Corporate Counsel Section, Mar. 3, 2009**

Agenda

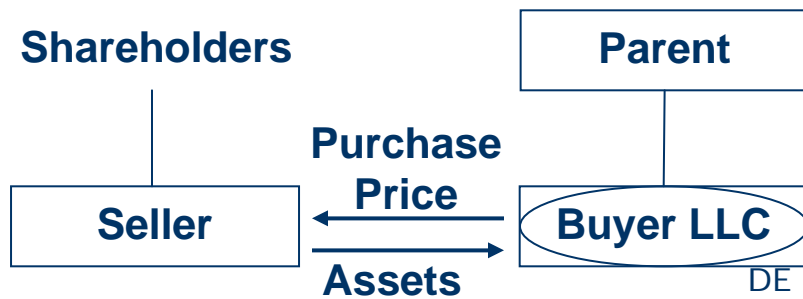
- **Taxable Asset Sale Transaction**
- **Taxable Equity Sale Transaction**

A non-comprehensive discussion of selected tax issues.

Significant excluded topics include cross-border tax issues, tax issues related to employee benefits, tax considerations relative to tax-free reorganizations, financial reporting for income taxes, etc.

Asset Sale Transaction

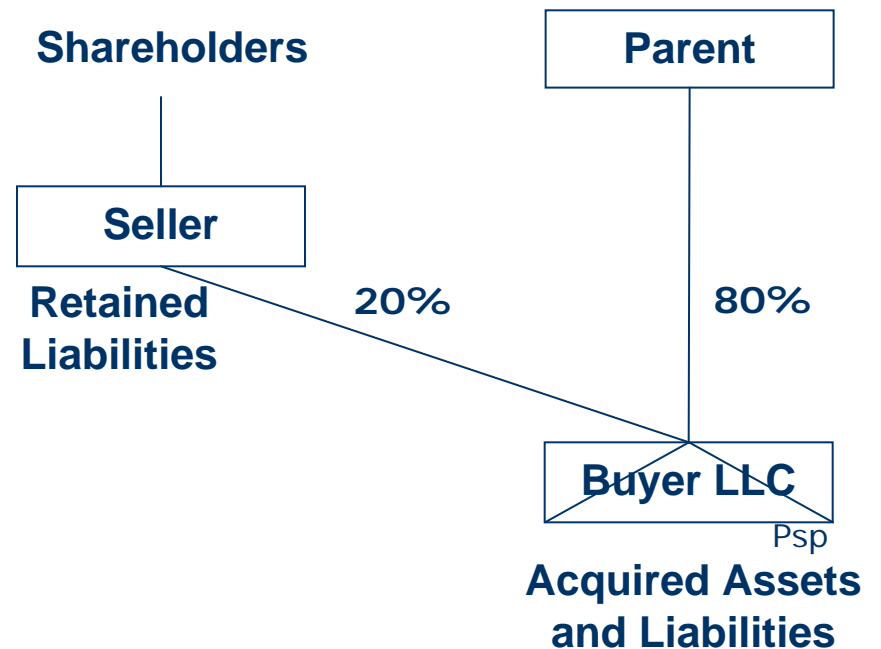
Transaction



Purchase Price

- Cash at closing
- Assumption of trade payables
- Cash in escrow
- Buyer note
- Buyer Equity (20%)
- Earn-out

Result



Asset Sale Transaction

- **Characterization of transaction**

- Buyer tax classification changes from a disregarded entity (single member LLC) to a partnership (multiple member LLC)
- Parent generally treated as having purchased an undivided 80% interest in Seller assets and assuming an undivided 80% liability for the assumed liabilities
- Then Parent and Seller are deemed to contribute the assets and liabilities to Buyer.

See Appendix 1 for alternative asset sale transaction structures

Asset Sale Transaction

- **Trap #1: Business Operating Before 1994**
 - §197(f)(9) anti-churning rule precludes Buyer's stepped up tax basis in intangibles (goodwill) if:
 - The intangible existed on 8/10/93 and wasn't eligible for amortization before that date
 - Seller owns (directly or through attribution) >20% of Buyer
 - Does earn-out or Buyer "note" count?
 - Does not apply if Seller elects to recognize gain as ordinary income at maximum applicable tax rates (generally a bad idea)

Asset Sale Transaction

- **Trap #2: Seller is a C Corporation**
 - Shareholders incur *double tax*:
 - Seller is taxed on gain on the sale of its assets
 - Shareholders are taxed again on receipt of after-tax sale proceeds either as a dividend or on liquidation of Seller
 - Effect is that Shareholders will generally insist on a stock sale, thereby depriving Buyer of a tax basis step up in Seller's assets
 - Exception if Seller has NOL, no gain, etc.
 - Exception if Shareholder is a C corporation and a member of a consolidated group with Seller

Asset Sale Transaction

- **Trap #3: Buyer is a C Corporation**
 - Seller's receipt of **Buyer equity might not be tax-free**
 - Tax rules for contributions to corporations (§351) require transferors to own 80% of the corporation
 - Parent and Seller together probably meet this requirement if Parent contributes acquisition cash to Buyer
 - Special rules for nonqualified preferred stock
 - No similar restriction for contributions to partnerships (including LLCs) (§721)

Asset Sale Transaction

- **Trap #4: Seller is an S Corporation**

- Seller corporation's gain may be characterized in part as ordinary income, whereas a sale of Shareholders' stock would be characterized as entirely capital gain
 - Same issue if sale of stock with a 338(h)(10) election (deemed asset sale election)
- Shareholders may ask Buyer to gross up the purchase price for **incremental tax due** on an actual or deemed sale of assets as compared to a straight sale of stock
 - Get agreement on calculation of incremental tax in advance if possible

Asset Sale Transaction

- **Trap #5: Purchase Price Allocation**

- **Proportional allocation:** IRS position is that each element of consideration must be spread among each of the assets acquired according to relative values
 - Result is that some equity is allocated to inventory and other properties that don't qualify for installment reporting, and some cash is allocated to goodwill which would otherwise qualify for installment reporting
- There is authority that the parties can agree to specially allocating specific elements of consideration to specific assets (e.g., allocate earn-out, note, and equity solely to goodwill)

Asset Sale Transaction

- **Trap #6: Covenant Not To Compete**

- Shareholders often grant a covenant not to compete to Buyer as part of the asset sale transaction; some Buyers assume that a portion of the purchase price must be allocated to the covenant
- Under old law, any amount allocated to the covenant was treated as ordinary income to Seller, but Buyer could deduct the payments over the covenant period
- Under current law, Seller has ordinary income as under prior law, but Buyer must amortize payments over 15 years; Seller suffers without any benefit to Buyer!
- Solution: **zero purchase price allocation** to covenant
 - Possible exception if Seller is a C corporation (trap #2)

Asset Sale Transaction

- **Trap #7: Shareholder Goodwill**

- Asset purchase agreement frequently requires Shareholders to contribute to Seller any assets used in Seller's business but owned by Shareholder
- Might make more sense to have Buyer purchase the asset directly from Shareholder that owns the asset
 - Helps **avoid double tax** where Seller is a C corporation (trap #2)
 - *See Martin Ice Cream v. Commissioner*, 110 T.C. 189 (1998); *Norwalk v. Commissioner*, T.C. Memo 1998-279

Asset Sale Transaction

- **Trap #8: Transfer Taxes**

- Generally no “bulk sale” or similar exemption
 - Inventory: resale exemption (get **resale certificate**)
 - Vehicles: generally taxable
 - Other personal property: occasional sale exemption
 - Real estate: real estate transfer tax in some states
 - Intangibles: nontaxable
- Texas occasional sale exemption applies in the case of a registered retailer only if there is a sale of “the entire operating assets of a business or of a separate division, branch, or identifiable segment of a business ...”
 - Retention/lease of even one operating asset triggers tax!
 - Seller must file a **Statement of Occasional Sale**

Asset Sale Transaction

- **Trap #9: Withholding Taxes**
 - Real Estate: get certificate of Seller's non-foreign status
 - State taxes: get tax clearance certificates
 - Timing of getting no tax due certificates may create problems and/or exposure to Buyer

Asset Sale Transaction

- **Trap #10: Texas Franchise Tax**

- **Location of the Payor Rule**

- If Buyer is a Texas entity, Seller sources gain on sale of intangible assets to Texas; increases portion of Seller's income (including gain on sale) that is subject to Texas franchise tax
- If Buyer is a non-Texas Buyer entity, Seller sources gain on sale of intangible assets outside Texas, thereby favorably diluting Seller's Texas apportionment factor for year of sale

- **Consider other franchise tax mitigation strategies** (e.g., distribution of assets prior to sale, sale of disregarded entity versus sale of assets, etc.)

Asset Sale Transaction

- **Franchise Tax Illustration**

- Facts

- Margin from operations = \$100
- Gain on sale = \$200, all from sale of goodwill
- 100% of operating income is from Texas sources

- If Buyer is a Texas entity, taxable margin = \$300

- If Buyer is a Delaware entity, taxable margin = \$100

- $\$300 \text{ total margin} \times \$100 \text{ TX receipts} \div \$300 \text{ total receipts}$

Asset Sale Transaction

- **Trap #11: Imputed Interest**

- Earn-out payments and purchase price adjustments received more than six months after sale (where at least one payment is made more than one year after sale) are treated as purchase price only to the extent of the “imputed principal amount”; excess is interest income
- Buyer and Seller might have to report some imputed interest under the accrual method according to the original issue discount (OID) regime

Asset Sale Transaction

- **Trap #12: Installment Method Limitations**
 - Interest charge on deferred tax for **sales >\$5 million**
 - Acceleration of gain on Seller's **disposition or pledging of installment obligation** (e.g., Buyer note)
 - 15-year basis allocation for wholly contingent payments
 - Ineligible property (cash basis receivables, inventory, depreciation recapture, etc.)

Asset Sale Transaction

- **Trap #13: The Year End Deal**
 - Buyers and Sellers are often motivated to try to close transactions by year end for emotional reasons
 - The Seller is often highly advantaged by closing on January 1 of year 2 versus December 31 of year 1
 - Full year depreciation for year 1
 - Up to one year deferral of payment of tax on sale
 - Special considerations may apply if the transaction is effectively closed in year 1 with only receipt of payment delayed until year 2

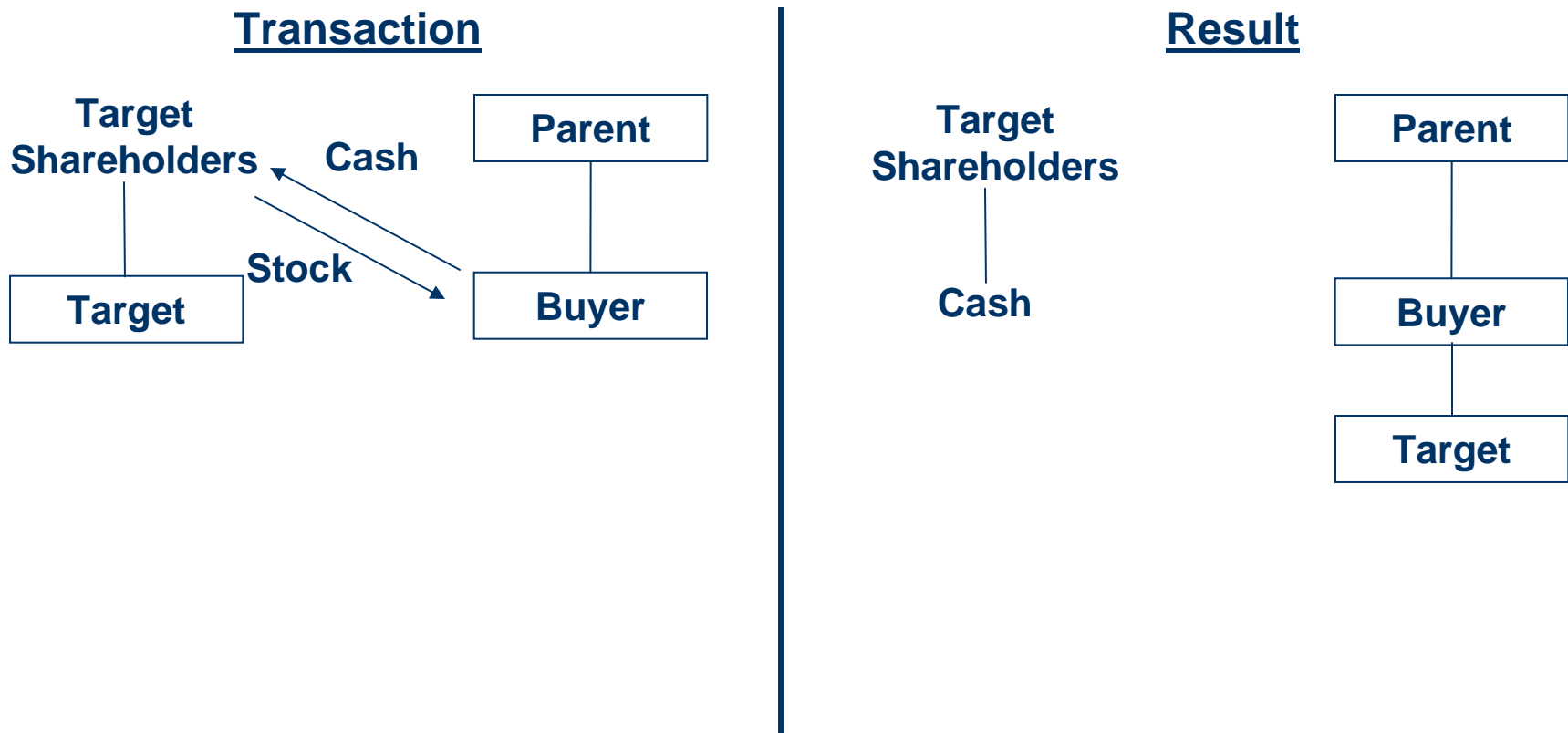
Asset Sale Transaction

- **Trap #14: Assumed Contingent Liabilities**

- Payment = purchase price, not a deduction
 - Seller treats as sale proceeds and imputed deduction
 - Buyer capitalizes purchase price when paid or incurred
 - *See Illinois Tool Works, Inc. v. Commissioner*, 355 F.3d 997 (7th Cir. 2004)
- Buyer should try to separate post-acquisition accruals, including imputed interest

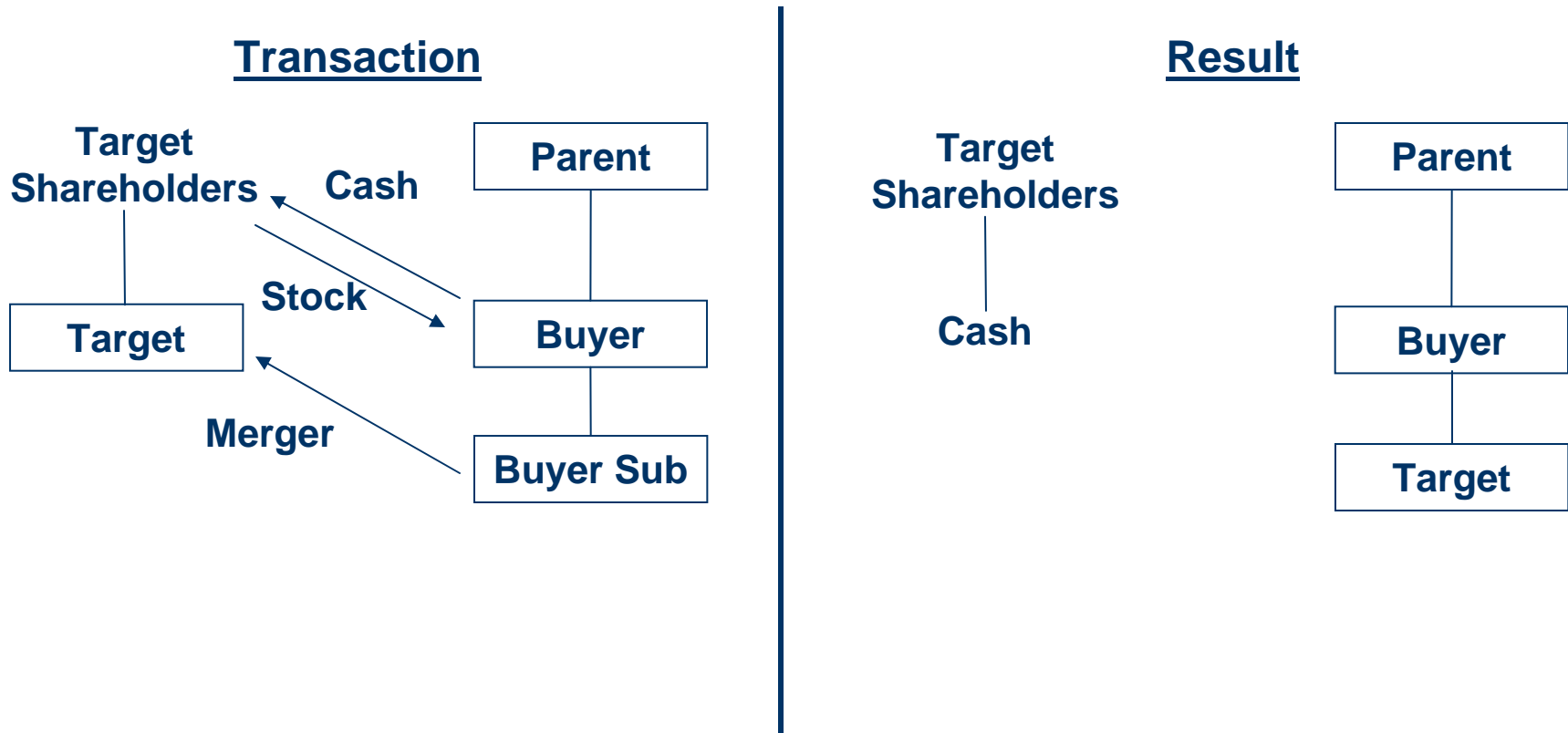
Equity Sale Transaction

- **Stock Purchase**



Equity Sale Transaction

- Reverse subsidiary merger



Equity Sale Transaction

- **Trap #1: Target is a C Corporation**
 - Buyer does not get a stepped up tax basis

Equity Sale Transaction

- **Trap #2: Target is an S Corporation**
 - If a 338(h)(10) election is to be made, all shareholders must consent and non-selling shareholders are taxed on their share of deemed asset sale gain
 - Buyer inherits risk of invalid or terminated S election
 - If Target's S corporation status is not valid or was terminated prior to sale, any 338(h)(10) election is invalid and Buyer inherits carryover basis and Target's **liability for unpaid corporate taxes**
 - Solution: forward subsidiary merger

Equity Sale Transaction

- **Trap #3: Bootstrap Acquisition**

- Buyer commits to pay a specified purchase price for Target stock (a C corporation)
- At closing, Buyer funds a portion of the purchase price with Target cash (e.g., borrowing against Target assets)
- Problem: Buyer might be deemed to receive a taxable dividend from Target
- Solution: agreement should obligate Target to make the distribution to Shareholders at closing, and Buyer's purchase price obligation should be reduced accordingly

Equity Sale Transaction

- **Trap #4: Joint/Several Tax Liability**
 - Target may have joint and several liability for taxes of any prior consolidated/combined group
 - This is now a problem for Texas franchise tax under the new combined reporting regime

Equity Sale Transaction

- **Trap #5: Tax Indemnity Cutoff**
 - Shareholder generally indemnifies against Target tax liabilities arising “on or before” the Closing Date
 - Tax effects of Buyer restructuring transactions occurring on the Closing Date should be carved out

Equity Sale Transaction

- **Trap #6: Prefunding Indemnities**
 - If Shareholder is providing an indemnity for pre-closing taxes, Seller should generally seek to exclude tax accruals from the calculation of equity and working capital
 - If accruals are not eliminated, Buyer will reduce purchase price by amount of accruals, thereby causing Seller to pre-fund the liabilities
 - Particularly acute where there are significant contingent tax liabilities (i.e., accruals for potential audit adjustments which are unlikely to be paid, if at all, until well into the future)

Equity Sale Transaction

- **Trap #7: Interperiod Adjustments**

- If Target shareholders provide a pre-closing period tax indemnity, they bear the burden of tax on disallowance of deductions claimed in the pre-closing tax period
- Certain of those deductions may result in tax basis increases that benefit Buyer in post-closing periods; the tax indemnity should account for this as an offset
- Similarly, consider procedures for allocating to Buyer the benefit of NOL or other carrybacks from post-closing periods into pre-closing periods

Equity Sale Transaction

- **Trap #8: Intermediary Transactions**

- If Buyer will sell >65% of acquired assets within 12 months after the closing and tax is “purportedly offset or avoided or not paid,” Seller could be deemed to have participated in a listed tax shelter transaction
- Consider including a negative covenant in the purchase and sale agreement:

Buyer shall not take any action with respect to the Target subsequent to the Closing that would cause the transactions contemplated hereby to constitute part of an “Intermediary Transaction” as described in I.R.S. Notice 2008-111.

DISCLAIMER

Information contained in this document is not intended to provide legal, tax, or other advice as to any specific matter or factual situation, and should not be relied upon without consultation with qualified professional advisors.

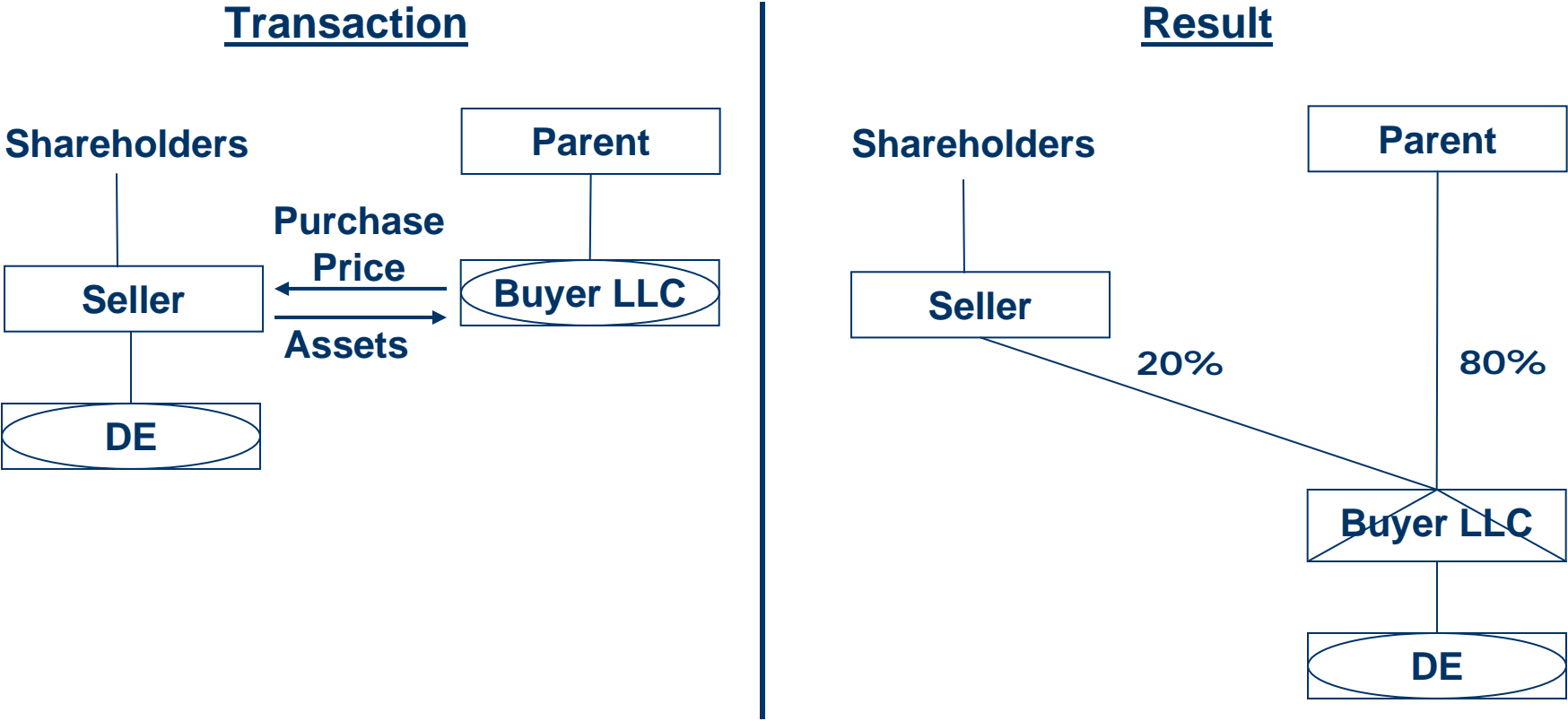
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APPENDIX 1

Alternative Asset Sale Transaction Structures

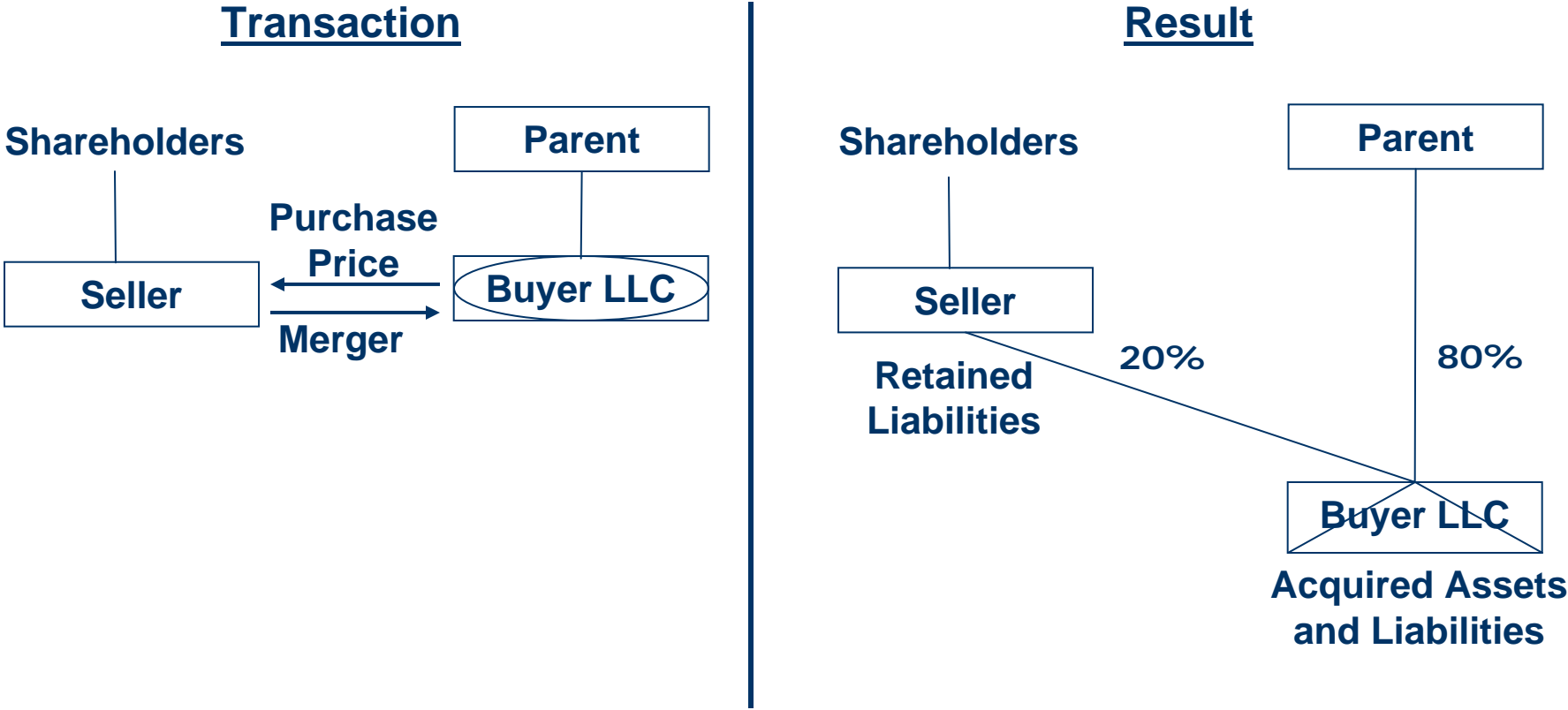
Asset Sale Alternatives

- Sale of disregarded entity (DE)



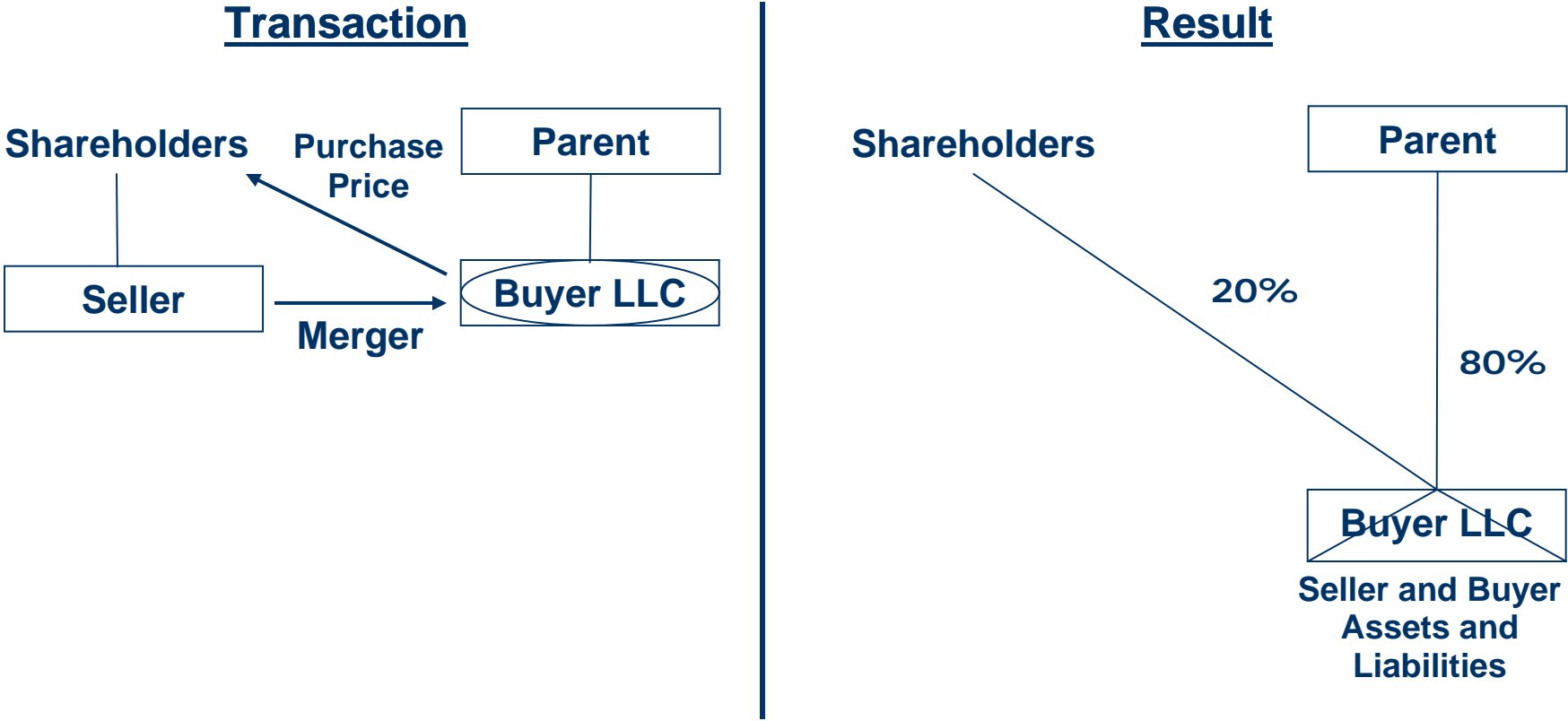
Asset Sale Alternatives

- Merger by division



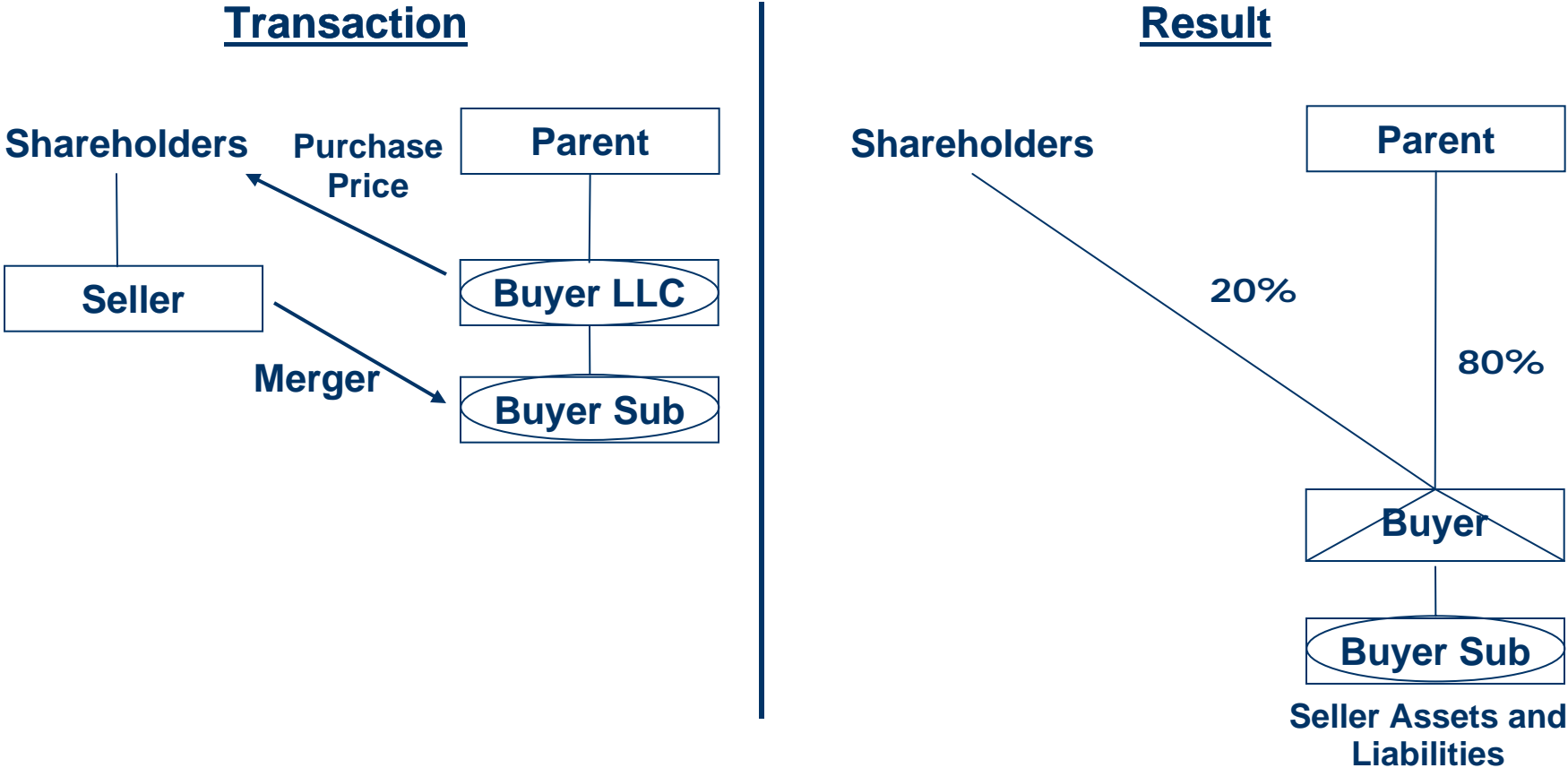
Asset Sale Alternatives

- Forward merger



Asset Sale Alternatives

- Forward subsidiary merger



Asset Sale Alternatives

- **Sale of disregarded entity**
 - More difficult to carve out unwanted liabilities
- **Merger by division**
 - Selected assets/liabilities transfer by operation of law
 - Seller survives and retains unwanted assets/liabilities
 - Treated as an asset acquisition for tax purposes
- **Forward merger**
 - Treated as sale of assets followed by liquidation of Seller
- **Forward subsidiary merger**
 - Same as forward merger plus drop down into Buyer Sub