

**Tax Aspects of Acquisitions and Dispositions of
Oil and Gas Properties:
Part II – Operating Business**

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Part I of this article (2009 Fall/Winter Edition) discussed certain federal income tax considerations relevant to the purchase or sale of individual oil and gas properties. This installment discusses some of the common tax issues that arise in the purchase and sale of an entire oil and gas business, including a purchase and sale of the assets of the business, or the purchase and sale of the equity of an entity that operates the business.

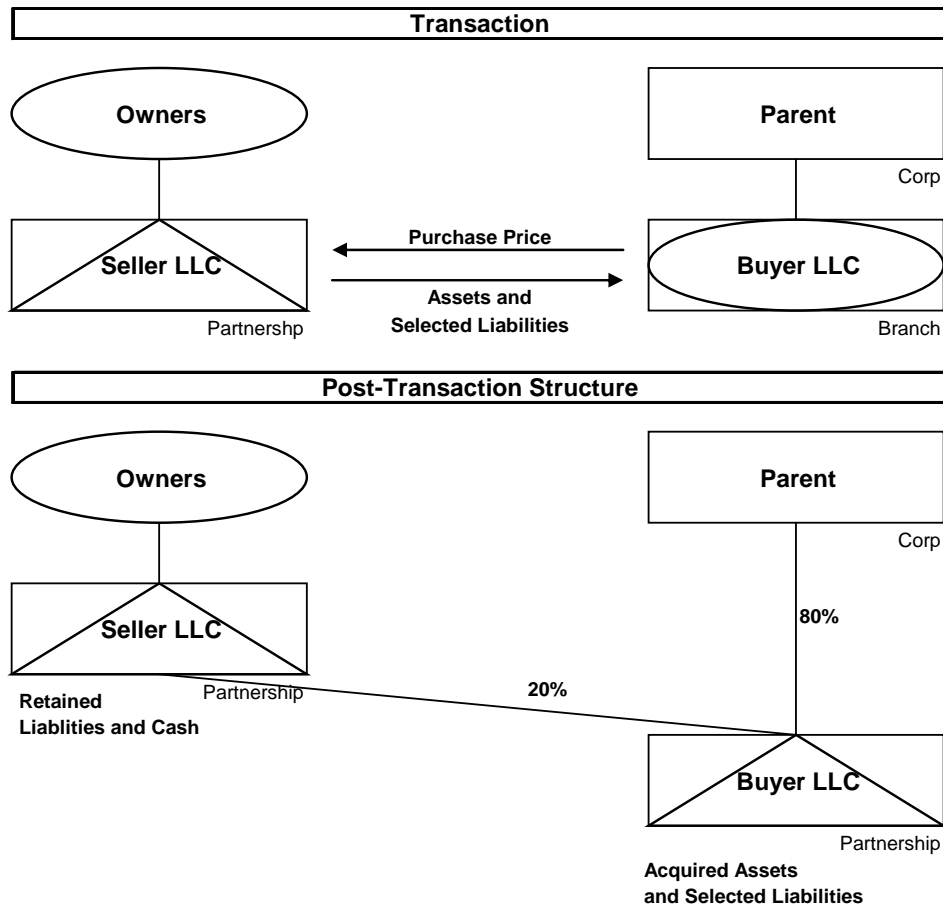
Taxable Purchase of Assets

Transaction Structure

Basic Transaction

For purposes of the discussion below, assume that the business to be acquired is owned by a closely held company (Seller) organized as limited liability company (LLC) owned primarily by individuals (Owners). Seller is classified as a partnership for federal income tax purposes. The acquiror (Parent) is a large oil and gas company organized as a C corporation for tax purposes. Parent will form an LLC subsidiary (Buyer) to purchase Seller's assets. Parent wants to acquire Seller's assets without inheriting Seller's liabilities (other than trade payables). Seller will retain a 20% equity interest in Buyer.

The transaction structure can be illustrated as follows:



The purchase consideration will consist of the following:

- Cash at closing, some of which will be used by Seller to pay off existing debt of the business that will not be assumed by Buyer (e.g., bank loans).
- Assumption of specified liabilities (e.g., trade payables).
- Specified deferred payments, or cash in escrow, to secure Seller's performance of representations, warranties, and covenants under the sale contract. The deferred payments or escrow is approximately 10% of the total cash consideration paid at closing, and will be paid out of escrow more than six months after closing. Seller is entitled to receive any earnings on the escrowed funds.
- Equity of Buyer representing a 20% interest.
- Employment agreements with Seller's owners and key management.
- Covenants not to compete.

The purchase agreement provides for a post-closing purchase price adjustment to account for differences between actual closing working capital and estimated closing working capital. The purchase agreement also provides for customary indemnification provisions whereby the parties indemnify each other against damages suffered due to breaches in representations, warranties, and other similar matters.

Alternative Transaction – Divisive Merger

An alternative to a sale and assumption of individual assets and liabilities is a forward merger transaction in which Seller merges into Buyer, with Buyer as the sole surviving entity. All of Seller's assets and liabilities become assets and liabilities of Buyer by operation of law, and Buyer consideration passes to Seller's owners. The transaction is treated for U.S. federal income tax purposes as a sale by Seller of its assets and liabilities to Buyer followed by a liquidation of Seller.¹ An advantage of a forward merger is that it simplifies the process of transferring properties from Seller to Buyer. But a significant disadvantage of a typical forward merger is that it does not afford Buyer the opportunity to choose the assets and liabilities to be acquired or assumed. A forward merger is therefore often not a practical alternative to an actual asset acquisition.

An unusual feature of the Texas merger statute is that each of the entities that participate in the merger may survive the merger, and the plan of merger may allocate the assets and liabilities of each entity participating in the merger among the entities that will survive the merger.² Such a merger is commonly referred to as a divisive merger. A divisive merger has the advantage of moving selected assets and liabilities to Buyer by operation of law (i.e., without the need for assignments and assumptions of individual assets and liabilities)³ while avoiding the disadvantage of requiring that all of Seller's assets and liabilities move to Buyer. Therefore, a divisive merger may be a desirable alternative to an assignment and assumption of individual assets under a traditional purchase and sale agreement.

For tax purposes, a divisive merger transaction is treated as a taxable sale by Seller of the assets that are allocated to Buyer in exchange for any Buyer assets allocated to Seller and the net liabilities of Seller assumed by Buyer.⁴ Where, as in the basic transaction above, Buyer is a disregarded entity, Seller is deemed to sell its assets to Parent rather than Buyer.⁵

¹ Rev. Rul. 69-6, 1969-1 C.B. 104.

² See Tex. Bus. Org. Code § 10.003.

³ Tex. Bus. Org. Code § 10.008(a)(2) provides that the assets allocated to a party as provided in the plan of merger become vested, subject to any existing liens or other encumbrances on the property, in that party "without reversion or impairment; any further act or deed; or any transfer or assignment having occurred." Similarly, Tex. Bus. Org. Code § 10.008(a)(4) provides that the party to which a liability is allocated under the plan of merger is the primary obligor for the liability, and except as otherwise provided by the plan of merger or by law or contract, no other party to the merger is liable for the liability.

⁴ Cf. Treas. Reg. § 1.368-2(a), (b)(1)(iii)(Ex. 1); Rev. Rul. 2000-5, 2000-1 C.B. 436.

⁵ Cf. Treas. Reg. § 1.368-2(b)(1)(iii)(Ex. 2).

Tax Characterization of Transaction

In the basic transaction described above, Buyer begins the transaction as a single member LLC, which is by default classified as a disregarded entity for federal tax purposes.⁶ Following the closing of the transaction, Buyer has two equity owners (Parent and Seller), which causes Buyer to be classified as a partnership for federal tax purposes.⁷ Accordingly, absent some special allocation of the purchase consideration among the acquired assets (see discussion below), the transaction will be treated for tax purposes as if Parent had purchased an 80% undivided interest in each of the assets acquired from Seller in exchange for the consideration other than Buyer equity, and then Parent and Seller contributed their respective 80% and 20% interests in the assets (subject to the assumed liabilities) to Buyer as a contribution to capital.⁸

With respect to the portion of the assets transferred by Seller to Buyer in exchange for Buyer equity, no gain or loss is recognized by Seller or Buyer.⁹ Seller's tax basis in Buyer equity received, and Buyer's tax basis in the contributed property, is equal to Seller's adjusted tax basis for the contributed property.¹⁰ Seller's and Buyer's holding periods for Buyer equity and contributed property, respectively, includes Seller's holding period for the contributed property.¹¹ The character of any gain or loss subsequently recognized by Buyer on the disposition of the contributed property is generally the same character as would have been recognized by Seller on a disposition of the property.¹²

Similar tax consequences apply to the portion of the assets deemed contributed by Parent to Buyer. The major difference is that Parent has a stepped up tax basis, and fresh start holding period, in the portion of the assets it has contributed. As a consequence, Buyer will have a split basis and holding period in each of the assets it has acquired.

If Buyer is a partnership or a multiple-member LLC, the sale transaction should still qualify for gain nonrecognition to the extent of Buyer equity issued as consideration for Seller's assets.¹³ If Buyer is a corporation, similar tax consequences should apply,

⁶ Treas. Reg. § 301.7701-3(b)(1).

⁷ *Id.*

⁸ *Cf.* Rev. Rul. 99-5, 1999-1 C.B. 434.

⁹ I.R.C. § 721(a).

¹⁰ I.R.C. §§ 722, 723.

¹¹ I.R.C. § 1223. If the transferor contributes multiple properties having different holding periods, the partnership interest received will apparently have a split holding period to the extent relevant to any subsequent disposition of the partnership interest. Treas. Reg. § 1.1223-3. *Cf.* Rev. Rul. 85-164, 1985-2 C.B. 117 (contribution of multiple properties to a corporation in a carryover basis transaction under I.R.C. § 351 results in a split holding period for the stock received in the exchange).

¹² I.R.C. § 724.

¹³ See Treas. Reg. § 1.707-3(f), *Example (1)* (transfer of assets to a partnership for cash and equity treated as part sale and part contribution).

although care must be taken to satisfy the specific requirements for a tax free incorporation transaction.¹⁴

Purchase Price Allocation

In General

In the case of any transfer of assets that constitute a trade or business in the hands of either the transferor or transferee (an “applicable asset acquisition”),¹⁵ for purposes of determining the transferor’s gain or loss, the consideration for the assets must be allocated among the assets in accordance with applicable Treasury Regulations.¹⁶ Those regulations generally provide that the consideration given in the transaction be allocated, in order, to specific classes of assets in proportion to and to the extent of the fair market value of each asset in such class, with any residual consideration being allocated to goodwill.¹⁷ If the parties agree in writing to the allocation (which is commonly required under asset purchase agreements), that allocation is generally binding on them, but is not binding on the Internal Revenue Service (“IRS”).¹⁸

A transfer may constitute an applicable asset acquisition notwithstanding the fact that no gain or loss is recognized with respect to a portion of assets transferred.¹⁹ Thus, in a transaction involving a simultaneous tax-free contribution and taxable sale of assets to a partnership (as described above), the entire transaction is considered in determining whether the transaction constitutes an applicable asset acquisition. However, the allocation of consideration is made without taking into account the assets transferred for non-recognition consideration or the non-recognition consideration (i.e., Buyer equity).²⁰

Note that the purchase price and allocation as calculated for tax purposes will not necessarily be equal to the purchase price and allocation as calculated for financial reporting purposes.²¹

¹⁴ I.R.C. § 351.

¹⁵ See Treas. Reg. § 1.1060-1(b).

¹⁶ I.R.C. § 1060(a); Treas. Reg. § 1.1060-1(a)(1) (reference to Treas. Reg. §§ 1.338-6 and 1.338-7).

¹⁷ Treas. Reg. § 1.338-6(b).

¹⁸ Treas. Reg. § 1.1060-1(c)(4). The parties can alter the agreed allocation only by offering proof that, in an action between the parties to the agreement, would be admissible to alter that construction or show its unenforceability because of mistake, undue influence, fraud, duress, etc.

¹⁹ Treas. Reg. § 1.1060-1(b)(8).

²⁰ Treas. Reg. § 1.1060-1(d) *Example (1)*.

²¹ Compare, e.g., Financial Accounting Standards Board, *Accounting Standards Codification* § 805-10-25-23 (transaction costs must be expensed), available at <http://asc.fasb.org/>, with Treas. Reg. § 1.263(a)-5 (most transaction costs must be capitalized).

Non-Pro Rata Allocation of Buyer Consideration

Where multiple properties are sold in exchange for a mix of consideration (e.g., cash, deferred payment obligations, and equity), there is authority for the position that Seller and Buyer can agree to allocate specific forms of consideration to specific items of transferred property if the allocation is documented, is supported by substantial non-tax business purposes, and is otherwise in accordance with the purchase price allocation rules described above.²² For example, the parties might treat transferred unrealized receivables and other property not eligible for installment method reporting (discussed below) as having been sold to Buyer for cash. Buyer equity would be allocated exclusively to zero basis goodwill. The balance of the consideration (cash and deferred payments) would be allocated to any remaining goodwill and other property eligible for installment method reporting.

It is unclear whether and under what circumstances the IRS will acquiesce to taxpayer initiated allocations of specific types of consideration to specific types of transferred assets in business acquisition transactions. The IRS initially took the position in proposed regulations that each form of consideration must be proportionately allocated among all transferred assets.²³ In response to comments questioning the validity of this requirement,²⁴ the requirement was withdrawn from the final regulations and the final regulations are silent on the issue.²⁵

In other contexts, where there is no specific allocation in the transaction documents, the IRS has held that a pro-rata allocation is required.²⁶ More recently, in the

²² Rev. Rul. 68-13, 1968-1 C.B. 195 (special allocation of down payment to inventory allowed in the context of an installment sale). See also Gregory J. Marich and Barksdale Hortenstine, *A Comprehensive Guide To Interpreting And Living With The Rules Governing Disguised Sales Of Property*, 110 Tax Notes 1421 (Mar. 27, 2006) (authorities cited at fn. 115); Ginsburg and Levin, *Mergers, Acquisitions, and Buyouts* ¶ 302.2.5 (Jul. 2009). But see Rev. Rul. 68-55, 1968-1 C.B. 140 (where several assets were transferred to a corporation, each asset must be considered transferred separately in exchange for a portion of each category of consideration received based on relative fair market values of the transferred assets and the consideration); Rev. Rul. 85-164, 1985-2 C.B. 117; Treas. Reg. § 1.358-2(b).

²³ See Preamble to Prop. Treas. Reg. § 1.707-3, 56 Fed. Reg. 19055 (Apr. 25, 1991) (“special rules apply to prevent a partner from selectively selling certain property (e.g., property with a high basis) and contributing other property to the partnership. The partner is required to allocate the amount realized from the disguised sale among all the properties transferred as part of a planned transaction, based on the relative fair market values of each property (reduced by any qualified liability with respect to that property).”)

²⁴ See New York State Bar Association Tax Section, Report On Proposed Section 707 Regulations Concerning Disguised Sales of Property Through Partnerships, 91 TNT 226-40 (Nov. 4, 1991) (text and authorities at fn 42).

²⁵ See T.D. 8439 (Sep. 30, 1992) (“In response to comments, the rule contained in the proposed regulations requiring a partner contributing multiple properties to a partnership to allocate the amount realized among the properties based on their values has been deleted. Thus, the final regulations do not provide special rules for the allocation of amounts realized in these transactions.”)

²⁶ See Rev. Rul. 68-55, 1968-1 C.B. 140 (“In determining the amount of gain recognized under section 351(b) ... where several assets were transferred to a corporation, each asset must be considered transferred separately in exchange for a portion of each category of consideration received. The fair market value of

context of a technical advice memorandum involving a deemed sale and contribution of assets to a partnership, the IRS appeared to affirmatively acknowledge that there were circumstances in which a non-proportionate allocation would be respected.

Thus, ... it appears that taxpayers have some residual ability to identify the assets that will be treated as sold, and the assets that will be treated as contributed. ... Based upon an examination of the authorities identified in the context of §§351 and 453, it appears that the ability to identify assets for divergent treatment is not unfettered. The case law appears to require both a business purpose for the different treatment, and factual indicia that the different treatment was understood and intended by the parties. ... Where there are not strong indications of different treatment, we believe that the appropriate treatment is a proportionate transfer of all underlying assets.²⁷

The technical advice memorandum was subsequently revoked and reissued to delete the quoted language. The reissued ruling refers to the deleted language as “incorrect” and provides no further explanation.²⁸ It is therefore again unclear whether and to what extent the IRS agrees that taxpayers have the ability to allocate different consideration to different assets in a single transaction.

Covenants Not to Compete

U.S. generally accepted accounting principles generally require Buyer to record an asset for a covenant not to compete entered into in connection with a business combination transaction if the covenant has material value.²⁹ Buyer and Seller sometimes wrongly assume that a corresponding allocation of purchase price to the covenant must be made for tax purposes.

Seller must report any consideration properly allocated to a covenant not to compete as ordinary income,³⁰ and Buyer amortizes that amount over 15 years (i.e., the same tax treatment as acquired goodwill).³¹ It will generally be to Seller’s advantage (with no associated detriment to Buyer) to expressly allocate zero value to the covenant not to compete, thereby minimizing Seller’s ordinary income and maximizing Seller’s long-term capital gain on sale of goodwill. Applicable case law indicates that no portion

each category of consideration received is separately allocated to the transferred assets in proportion to the relative fair market values of the transferred assets.”).

²⁷ Tech. Adv. Mem. 200512020 (Mar. 25, 2005) (citations omitted).

²⁸ Tech. Adv. Mem. 200650017 (Dec. 15, 2006).

²⁹ See Financial Accounting Standards Board, *Accounting Standards Codification* (ASC) §§ 805-20-25-1, 805-20-55-11, 805-20-55-14(e).

³⁰ *Ullman v. Commissioner*, 264 F.2d 305 (2nd Cir. 1959) (“It is well established that an amount a purchaser pays to a seller for a covenant not to compete in connection with a sale of a business is ordinary income to the covenantor and an amortizable item for the covenantee unless the covenant is so closely related to a sale of good will that it fails to have any independent significance apart from merely assuring the effective transfer of that good will.”).

³¹ I.R.C. § 197(d)(1)(E) (15-year amortization applies to “any covenant not to compete ... entered into in connection with an acquisition (directly or indirectly) of an interest in a trade or business or substantial portion thereof”); Treas. Reg. § 1.197-2(b)(9).

of the purchase price is allocated to a covenant not to compete unless the parties clearly indicate an intention to have a portion of the purchase price allocated to the covenant.³² The theory of these cases is that the parties perception of the value of the covenant may differ significantly, and the covenant may reasonably be viewed as inherent in making an effective transfer of goodwill. If the purchase agreement expressly states that no portion of the purchase price will be allocated to any covenant not to compete granted in the transaction, the provision should be respected for tax purposes. The fact that Buyer might be required for financial accounting purposes to record an asset for the acquired covenant should not invalidate a zero allocation for tax purposes.³³

In many cases, not only will Seller enter into a covenant not to compete, but Buyer will also insist that Seller's owners and key managers enter into covenants not to compete (to the extent they do not enter into on-going employment agreements or consulting agreements containing equivalent Buyer protections). Covenants not to compete granted by persons other than Seller are technically outside the scope of the purchase price allocation rules. However, as part of reporting the purchase price allocation, Buyer and Seller must report whether any such covenants were purchased and the maximum consideration payable under each covenant.³⁴ Moreover, because the tax consequences of any such covenants are the same as the tax consequences of a Seller covenant (discussed in the immediately preceding paragraph), Buyer and Seller generally would be best served to specifically allocate zero consideration to such covenants. Different considerations might apply if Seller is a C corporation (see discussion of shareholder goodwill below in connection with sale of stock of a C corporation).

Assumed Liabilities

To the extent Buyer assumes a Seller fixed and determinable liability³⁵ as part of the consideration for the transferred assets, the amount of assumed liability is included in Seller's amount realized for the transferred assets.³⁶ If Seller has not previously taken the

³² *Annabelle Candy Co. v. Commissioner*, 314 F.2d 1 (9th Cir. 1962) ("if the parties did not intend that a part of the purchase price be allocated to this important and valuable covenant, that intention must be respected."). See also *Better Beverages, Inc. v. United States*, 619 F.2d 424 (5th Cir. 1980) (unless the parties mutually intended that a portion of the consideration be allocated to a covenant not to compete, no portion of the purchase price may be so allocated; therefore, where agreement was silent on the allocation of purchase price, zero was allocated to the covenant not to compete); *Becker v. Commissioner*, T.C. Memo 2006-264 (Dec. 13, 2006) (same).

³³ *Thor Power Tool Co. v. Commissioner*, 439 U.S. 522 (1979) (financial accounting rules do not control tax reporting).

³⁴ I.R.C. § 1060(e) (reporting requirement for certain agreements with 10% owners and certain related persons); IRS Form 8594 – Asset Acquisition Statement Under Section 1060 (rev. Feb. 2006), Part II, Line 6 (reporting required for specified agreements with Seller or managers, directors, owners, or employees of Seller).

³⁵ Liabilities are fixed and determinable to the extent all events that determine the fact of liability have occurred and the amount of the liability can be determined with reasonable accuracy. See I.R.C. § 461(h)(4).

³⁶ Treas. Reg. § 1.1001-2(a).

liability into account under Seller's method of accounting (e.g., cash basis trade payables), Seller should be treated as having paid the liability at the time of the sale and should deduct or capitalize the deemed payment as appropriate.³⁷ Buyer generally includes the assumed liabilities in the cost basis for the assets acquired as of the date of sale, or if later, the date that economic performance occurs with respect to the assumed liability.³⁸

To the extent Buyer assumes Seller liabilities that are not fixed and determinable as of the closing date (i.e., contingent liabilities, such as pending lawsuits), Seller generally must include the fair market value of the liability assumption in income as part of the sale proceeds,³⁹ and is entitled to an offsetting deduction for the deemed payment of the liability.⁴⁰ If the value of the liability cannot be reasonably ascertained and the parties did not specifically negotiate a specific purchase price adjustment to account for Buyer's assumption of the liability, Seller will generally defer recognition of the liability assumption in amount realized, and the corresponding deemed payment of the liability, until the liability becomes fixed and determinable. Buyer does not include any amount in its purchase price until the liability is paid or otherwise incurred for tax purposes.⁴¹

A significant issue for Buyer is the extent to which amounts paid or incurred by Buyer after the asset acquisition with respect to the acquired business will be deductible as Buyer operating expenses. The IRS may try to characterize such Buyer expenses as attributable to events occurring prior to the acquisition (i.e., as payments of assumed liabilities), with the result that the Buyer must capitalize the amounts as part of the purchase price for the acquired assets, significantly deferring Buyer's tax benefit for the expense. Buyer should carefully analyze all assumed liabilities to distinguish between liabilities that are properly attributable to the pre-closing period (because the events giving rise to the liability occurred in the pre-closing period) and those liabilities that are

³⁷ See generally Ginsburg and Levin, *Mergers, Acquisitions, and Buyouts* ¶ 304 (July 2009). Accrued qualified pension plan liabilities are generally treated by the IRS as deductible by the Buyer when paid (i.e., are not considered a purchase price adjustment), whereas accrued non-qualified deferred compensation is treated by the IRS as additional purchase price, but Seller's deduction is apparently allowed, if at all, only when the deferred compensation is includible in the income of the employees). *Id.* ¶ 304.3 (reference to I.R.C. § 404(a)(5) and Ltr. Rul. 8939002 (June 9, 1989)).

³⁸ Rev. Rul. 55-675, 1955-2 C.B. 567 (inclusion of assumed liabilities in cost basis); T.D. 9358, 69 Fed. Reg. 55740 (Sep. 16, 2004) (noting that Treas. Reg. § 1.461-4(d)(5), providing for acceleration of economic performance of liabilities assumed in a sale of a business, applies only to Seller and does not address the tax treatment of Buyer).

³⁹ *Cf.* Treas. Reg. § 1.1001-1(a) (amount realized includes the fair market value of property received, and only in "rare and extraordinary" cases will property be considered to have no fair market value).

⁴⁰ *Cf.* Tech. Adv. Mem. 9125001 (Dec. 24, 1991) (in a deemed sale of assets under I.R.C. § 338(h)(10), old T is allowed a deduction when the adjusted deemed selling price is adjusted to account for new T's payment of assumed contingent liabilities). See Treas. Reg. § 1.461-4(j) (subject of economic performance with respect to contingent liabilities is reserved).

⁴¹ Treas. Reg. §§ 1.446-1(c)(1)(ii), 1.461-1(a)(2)(i); *Illinois Tool Works v. Commissioner*, 355 F.3d 997 (7th Cir. 2004). Buyer may not claim a deduction for any portion of the assumed liability attributable to the pre-closing period, even if the amount ultimately paid to settle the liability exceeds the amount estimated at closing. *Id.*

properly attributable to the post-closing period. The latter category are properly deducted by Buyer rather than added to Buyer's purchase price for the assets.

Buyer must also be aware of recent changes to financial accounting rules that treat most changes to assumed values for contingent consideration, contingent assets, and contingent liabilities as period expenses rather than as adjustments to goodwill.⁴² Although the adjustments are treated as period expenses for financial accounting purposes, the adjustments will often be treated as purchase price adjustments for tax purposes, significantly deferring the tax benefit of the expenses.

Deferred Payments

Installment Method

Seller's gain or loss realized on the assets sold to Buyer is computed taking into account the value of all property received as consideration for the transferred assets, including the issue price of any Buyer deferred payment obligations.⁴³ Seller's realized gain on an asset is recognized under the installment method if one or more payments for the asset are to be received after the close of the taxable year of the sale and the other requirements for application of the installment method are satisfied.⁴⁴ In general, the installment method causes the Seller's realized gain to be recognized each year in proportion to the contract payments (net of assumed liabilities) received in that year. In effect, the Seller's basis in the asset sold is first applied against assumed liabilities, and then is spread to the remaining payments proportionately.⁴⁵

A potentially problematic aspect of the installment method as applied to sales of operating businesses is the treatment of contingent payments. If the contract neither specifies a maximum selling price nor limits payments to a fixed period, the installment method is generally applied by recovering Seller's basis ratably over a 15 year period.⁴⁶ This can significantly distort Seller's gain recognized in early years.

⁴² See Financial Accounting Standards Board, *Accounting Standards Codification* § 805-10-35-1 (2010).

⁴³ Treas. Reg. § 1.1001-1(a), (g)(1)

⁴⁴ I.R.C. § 453. For this purpose, Buyer's deferred payment obligation is not treated as a payment until the amounts due under the deferred payment obligation are made. Treas. Reg. § 15a.453-1(b)(3).

⁴⁵ Treas. Reg. § 15a.453-1(b)(2). A complete analysis of the installment method is beyond the scope of this article. The application of the installment method to sales of individual oil and gas properties was discussed briefly in Part 1 of this article. See Browne, *Tax Aspects of Acquisitions and Dispositions of Oil and Gas Properties: Part I – Individual Properties*, 28 *Petroleum Acct. and Fin. Mgmt. J.* 39, at pp. 50-52 (Fall 2009). A more comprehensive analysis of installment sales generally can be found at Bittker & Lokken, *Federal Taxation of Income, Estates, and Gifts*, ¶ 106.1 (2009).

⁴⁶ Treas. Reg. § 15a.453-1(c)(4). Seller can request a ruling from the IRS granting Seller the right to use a different basis recovery method if the 15 year spread rule would substantially and inappropriately defer recovery of Seller's basis. Treas. Reg. § 15a.453-1(c)(7).

The terms of the basic transaction above appear, in form, to provide for a specified maximum selling price. Accordingly, it appears that Seller's gain would initially be recognized under the installment method assuming Buyer's deferred payment obligation (including any escrow account) would be paid in full. What is unclear is whether Buyer's assumption of a contingent liability might cause the transaction to be viewed as a contingent payment sale that is subject to the 15 year basis recovery rule. Although the regulations do not specifically address this issue, it appears that the assumed contingent liability would not be taken into account in calculating the "selling price" under the installment method, and therefore should not cause the transaction to be classified as a contingent payment sale. Buyer's assumption of the assumed contingent liability would be added to the selling price only at the time Buyer pays or incurs the liability for tax purposes.

To minimize the potential adverse tax effects of deferred contingent payments and assumed contingent liabilities on Seller's reporting of gain under the installment method, Seller should consider specifically allocating the contingent consideration to zero basis goodwill. The effect is that Seller reports gain only as the payments are received, and there will be no basis distortion because there is no basis to spread.

Limitations on Installment Method

There are several important limitations on Seller's use of the installment method that Seller and its advisors often overlook.

One limitation is the limitation on the types of property and gain eligible for reporting under the installment method. In general, property of a type that produces ordinary income on sale (e.g., receivables from sales of inventory or services, inventory, property subject to the depreciation recapture rules) will not be eligible for the installment method to the extent of the ordinary income realized in the sale.⁴⁷ In addition, intangible drilling costs and depletion recapture amounts will be reported as ordinary income before any capital gain is reported.⁴⁸ It is because of these limitations that a specific allocation of purchase consideration (i.e., deferred payments) to qualifying property might be beneficial to Seller and Buyer.

A second limitation is the \$5,000,000 annual limitation on material installment sales. If the sales price for any sale reported under the installment method exceeds \$150,000 (a "material installment sale"), and if the total face amount of obligations outstanding at the end of a taxable year arising from material installment sales during the taxable year exceeds \$5,000,000, the taxpayer is required to pay an interest charge on the

⁴⁷ I.R.C. §§ 453(b)(2) (inventory); 453(i) (recapture income); *Berger v. Commissioner*, T.C. Memo 1996-76 (RIA) (receivables generated by sales of inventory); *Sorensen v Commissioner*, 22 T.C. 321 (1954) (receivables representing compensation for services).

⁴⁸ Treas. Reg. § 1.1254-1(d). This front-loaded ordinary income recognition rule is apparently applied on an asset-by-asset basis, consistent with the application of the installment method to individual assets rather than to the transaction as a whole.

tax deferred under the installment method on the amount in excess of \$5,000,000.⁴⁹ The effect is to allow Seller to defer payment of the tax until cash is received, but to require Seller to pay an interest charge on the deferred tax amounts on the sales price above \$5,000,000. This interest charge generally negates any benefit of the installment method for the amount in excess of \$5,000,000.

A third important limitation is the limitation on dispositions or pledging of installment obligations.⁵⁰ Seller's opportunity to monetize Buyer's deferred payments – such as through a sale of the Buyer note or escrow rights, or through a borrowing against those receivables – are limited by these rules.

Open Transaction Method

In situations where Buyer contingent payments might produce undesirable results under the installment method, or where the limitations imposed under the installment method defeat the intended benefits of the method or Seller's flexibility in monetizing the deferred payments, Seller might consider whether the transaction can properly be reported under the open transaction method. The open transaction method is available in those "rare and extraordinary cases" in which the fair market value of a contingent payment obligation is "not reasonably ascertainable."⁵¹ Under the open transaction method, Seller's gain is computed by applying Buyer payments against basis first, and then reporting the payments as gain. Deferred payments are subject to the imputed interest rules discussed below, but are not subject to the basis allocation, interest charge, and anti-pledging rules applicable to installment sales.

Imputed Interest

If the consideration for the purchase of Seller's assets includes a contractual obligation to make fixed payments more than 6 months after the date of sale, and if the deferred payment obligation (or promissory note evidencing the obligation) does not provide for adequate stated interest, then the deferred payment obligation is generally treated as a debt instrument having a principal amount equal to the present value of the deferred payments due under the obligation (the "imputed principal amount").⁵² In most

⁴⁹ I.R.C. § 453A(a)(1). Interest is calculated using the rate applicable to tax underpayments under I.R.C. § 6621(a)(2) as of the end of the applicable tax year (4% as of 12/31/09).

⁵⁰ I.R.C. §§ 453A(d) (anti-pledging rules); 453B (dispositions).

⁵¹ Treas. Reg. § 15a.453-1(d)(2)(iii); Treas. Reg. § 1.1001-1(a), (g)(2)(ii). See *Burnet v. Logan*, 283 U.S. 404, 413 (1931) (payments based on production from mine); *Westover v. Smith*, 173 F.2d 90 (9th Cir. 1949) (payments contingent on sales of equipment manufactured by buyer under patents acquired in purchase of seller's business); *Gralapp v. United States*, 458 F.2d 1158 (10th Cir. 1972) (payments contingent on future production from oil and gas leases); *Steen v. United States*, 509 F.2d 1398 (9th Cir. 1975) (payments contingent on outcome of pending tax controversy). Transactions reported under the open transaction method will be closely scrutinized to determine whether a true sale has taken place. Treas. Reg. § 15a.453-1(d)(2)(iii).

⁵² I.R.C. § 1274(a)(2), (b)(1), (c)(1)(B). See also Treas. Reg. § 1.1275-1(d) (defining debt instrument to include "any instrument or contractual arrangement that constitutes indebtedness under general

cases, the imputed principal amount is calculated using the lowest “applicable Federal rate” specified in I.R.C. § 1274(d), compounded semiannually, for the three-month period ending with the first calendar month in which there is a binding contract in writing for the sale.⁵³ The difference between the stated amounts payable under the deferred payment obligation and its imputed principal amount represents original issue discount (“OID”) that is recognized in income by Seller, and is deductible by Buyer, over the term of the debt instrument using a constant yield to maturity accounting method.⁵⁴ This requirement to accrue OID during the term of the instrument generally applies even where Seller or Buyer is on the cash method of accounting.⁵⁵

The OID rules of I.R.C. § 1274 apply only to “debt instruments” issued for property, with certain specified exceptions. Some transactions that are excepted from the OID rules may be subject to I.R.C. § 483, which provides for imputed interest under similar rules. For example, sales of property involving total consideration of less than \$250,000 are excepted from the OID rules of I.R.C. § 1274,⁵⁶ but such sales may be subject to the imputed interest rules of I.R.C. § 483. Contingent deferred payments that are not “debt instruments” are subject to I.R.C. § 483 rather than I.R.C. § 1274.⁵⁷ The principal difference between the OID rules in I.R.C. § 1274 and the imputed interest in I.R.C. § 483 is that OID is accrued by Seller and Buyer over the term of the debt instrument (regardless of their normal method of accounting), whereas imputed interest is recognized according to their normal method of accounting. Thus, imputed interest attributable to each deferred payment is reported by Buyer and Seller when paid (in the case of a cash method taxpayer) or when the payment is due (in the case of an accrual method taxpayer).⁵⁸

If an interest-free deferred payment obligation provides for payments that are contingent in amount or timing, or both, it is not possible to compute the imputed principal amount under the rules discussed above. Accordingly, under special rules applicable to contingent payment obligations, each contingent payment is treated as a payment of principal to the extent of the present value of the payment, and as interest to the extent the payment exceeds its present value.⁵⁹ The present value of the payment is

principles of Federal income tax law”). Exceptions apply to certain transactions or debt instruments. See I.R.C. § 1274(c)(3) and Treas. Reg. § 1.1274-1(b).

⁵³ I.R.C. § 1274(b)(2)(B), (c)(2). For debt instruments having a stated principal amount of less than an indexed threshold, the rate may not exceed 9%, compounded semiannually. I.R.C. § 1274A(a). The threshold is \$5,115,100 for transactions in 2010. Rev. Rul. 2010-2, 2010-3 I.R.B. 272.

⁵⁴ I.R.C. §§ 1273(a)(1), 1272(a)(1), 163(e).

⁵⁵ But see I.R.C. § 1274A(c) (election to report on the cash method for certain debt instruments having a principal amount less than an indexed threshold). The threshold is \$3,653,600 for transactions occurring in 2010. Rev. Rul. 2010-2, 2010-3 I.R.B. 272.

⁵⁶ I.R.C. § 1274(c)(3)(C).

⁵⁷ See Keyes, *Federal Taxation of Financial Instruments & Transactions*, ¶ 4.01, n. 16 (2009).

⁵⁸ Treas. Reg. § 1.483-2(a)(1)(ii).

⁵⁹ The obligation to pay the payments that are contingent as to amount or timing (such as an earn out amount) is likely not a “debt instrument” for purposes of I.R.C. § 1274 (because there is no fixed obligation

calculated by discounting the payment at the “test rate” from the payment date to the issue date.⁶⁰ The test rate is the lowest applicable Federal rate (based on the term from the issue date to the payment date using the appropriate compounding period) in effect during the 3 month period ending with the month in which the sale agreement is entered into.⁶¹

Buyer’s settlement of Seller liabilities assumed in the purchase and sale transaction generally do not give rise to imputed interest. If the assumed liability is sufficiently fixed and determinable to be classified as a Seller “debt instrument,” Buyer simply steps into Seller’s shoes with respect to the existing terms of the debt instrument.⁶² As a result, any valuation discount for the assumed debt instrument is reflected as purchase price on the date of the assumption rather than as interest when paid. If the assumed liability is not properly classified as a Seller “debt instrument,” it is arguable that Buyer’s settlement of the liability constitutes a constructive deferred payment by Buyer to Seller, and that interest should be imputed on the payment under I.R.C. § 483. However, an assumed contingent liability is generally not treated a deferred payment obligation for purposes of the imputed interest rules.⁶³

Escrowed Purchase Price

Amounts paid by Buyer into an escrow account to secure Seller’s obligation to indemnify Buyer against breaches of representations and warranties or other events specified in the sale contract can be reported by Seller under the installment method (if the method is otherwise applicable) even though the escrow is not technically a payment obligation of Buyer.⁶⁴ For this purpose, the “selling price” for installment method purposes should include the maximum amount to be distributed to Seller under the terms of the escrow arrangement, excluding any earnings on the escrow funds paid to Seller with respect to periods that the funds are held in escrow for Seller’s benefit.

to pay a sum certain), and therefore the obligation is likely governed by I.R.C. § 483. Treas. Reg. § 1.483-4(a) provides that each payment is treated as part interest and part principal under rules similar to those applicable to a contingent payment debt instrument issued for property (i.e., Treas. Reg. § 1.1275-4(c)). Thus, whether the obligation constitutes a debt instrument is generally irrelevant.

⁶⁰ Treas. Reg. § 1.1275-4(c)(4)(ii).

⁶¹ *Id.*; Treas. Reg. § 1.1274-4(a)(1)(ii).

⁶² I.R.C. § 1274(c)(4); Treas. Reg. § 1.1274-5(d). This rule assumes that the debt instrument is not modified as part of the assumption transaction.

⁶³ *Tribune Publishing Company v. United States*, 836 F.2d 1176 (9th Cir. 1988) (no imputed interest on payment of contingent liability inherited in a merger transaction). *But see* Youngwood, *The Tax Treatment of Contingent Liabilities in Taxable Asset Acquisitions*, 44 Tax Lawyer 765, 772 n.41 (1991) (arguing that the holding in *Tribune Publishing* is inconsistent with I.R.C. § 483).

⁶⁴ IRS Publication 537 (2010), *Installment Sales* p. 6 (“If an escrow arrangement imposes a substantial restriction on your right to receive the sale proceeds, the sale can be reported on the installment method, provided it otherwise qualifies. For an escrow arrangement to impose a substantial restriction, it must serve a bona fide purpose of Buyer, that is, a real and definite restriction placed on the seller or a specific economic benefit conferred on Buyer.”). *See also* Rev. Rul. 79-91, 1979-1 C.B. 179; Ltr. Rul. 200521007 (Feb. 25, 2005); Ltr. Rul. 8645029 (Aug. 8, 1986); Ltr. Rul. 8629038 (April 18, 1986).

The IRS is required to issue regulations specifying the taxation of earnings on amounts held in escrow,⁶⁵ including escrow funds established in connection with the sale of a business to secure Seller's indemnity obligations (a "contingent at closing escrow"). The IRS published proposed regulations applicable to contingent at closing escrows in 1999. The proposed regulations provide that, in computing taxable income, Buyer must take into account all tax items of the escrow until the contingencies are resolved, and thereafter Buyer and Seller must each take into account the tax items that correspond to their respective ownership interests in the escrow. While this proposed regulation has not been withdrawn, in February 2006 the IRS deferred finalization of the regulation stating that the tax treatment of contingent at closing escrows requires further consideration.⁶⁶ In the absence of compulsory IRS guidance, an agreement between Seller and Buyer to have Seller report income earned on the escrowed portion of the purchase price for the purchase of a business should be respected for tax purposes where the escrow is entered into to for the sole purpose of securing Seller's indemnity obligations and is not substantially likely to be forfeited to Buyer.⁶⁷

Under the theory that amounts owed pursuant to an escrow arrangement constitute installment sale payments (see above), the arrangement might be viewed as a debt instrument subject to the OID or imputed interest rules discussed above under "Deferred Payments." The better view is that where Seller receives and includes in its taxable income the earnings on the escrowed funds, there is no original issue discount or imputed interest. The arrangement is more properly viewed as a security deposit rather than as a debt instrument for purposes of the OID and imputed interest rules.

Pre-Closing Net Profits Allocation

It is not uncommon in oil and gas transactions for the parties to agree that the net profits earned with respect to the purchased properties for the gap period between the date the purchase and sale agreement is signed and the date the sale transaction closes are for Buyer's account.⁶⁸ Buyer typically reduces the purchase price to account for the gap period net profits, and Seller retains the net profits. Alternatively, Seller might pay the gap period net profits to Buyer and make no adjustment to the purchase price.

Seller and Buyer might assume that because the income is for Buyer's account, Buyer is responsible for taxes on the net profits. This is generally incorrect. In most cases, the ownership of the underlying property will not transfer to Buyer until the

⁶⁵ I.R.C. § 468B(g)(1) ("nothing in any provision of law shall be construed as providing that an escrow account, settlement fund, or similar fund is not subject to current income tax. The Secretary shall prescribe regulations providing for the taxation of any such account or fund whether as a grantor trust or otherwise.").

⁶⁶ T.D. 9249 (Feb. 3, 2006).

⁶⁷ Cf. Prop. Treas. Reg. § 1.468B-8(h)(2) (for periods prior to the proposed effective date of the proposed regulations, the IRS stated it "will not challenge a reasonable, consistently applied method of taxation for income earned by the escrow").

⁶⁸ Ltr. Rul. 8718003 (Jan. 7, 1987).

closing date, and Seller, as owner of the properties during the gap period, is required to report and pay tax on the net profits generated by the properties during that period. Seller's agreement to account to Buyer for the gap period net profits is viewed as a purchase price adjustment that reduces Seller's amount realized on the sale.⁶⁹ Accordingly, Seller will generally want to make sure that net profits to be allocated to Buyer is computed on an after-tax basis.

Purchase Price Adjustments

Post-Closing True-Ups

If Buyer is required to make an additional payment to Seller after the closing of the purchase to reflect, for example, the amount by which working capital at the closing date (as determined based on a post-closing audit) exceeds estimated closing working capital, the additional payment is generally characterized as additional purchase price. If the adjustment is paid more than six months after closing, and if one or more payments under the purchase agreement is due more than one year after closing, Buyer's purchase price adjustment payment will be characterized, in part, as imputed interest.⁷⁰ If the purchase price is reduced due to a working capital short fall, and either Seller is required to make a payment to Buyer or Buyer's deferred payments due to Seller are adjusted, Seller recalculates its amount realized and gain or loss on the sale.⁷¹ Buyer makes a corresponding adjustment to its tax basis for the purchased assets.

Settlement of Assumed Liabilities

Buyer's purchase price for the acquired assets includes payments it makes to settle assumed liabilities that were not accounted for in Buyer's basis for the acquired assets as of the closing because the amounts payable could not be reasonably ascertained or because economic performance had not occurred with respect to the assumed liability.⁷² Buyer's purchase price adjustment includes only the portion of the liability that is attributable to periods prior to closing. Buyer's payment of post-closing amounts (such as legal fees incurred after the closing date to resolve the liability, or interest on the liability accruing post-closing) represent Buyer expenses and do not affect Buyer's purchase price for the acquired assets, even if the post-closing amounts were taken into account by Buyer when setting the cash portion of the purchase price to be paid by Buyer to Seller for the business.

⁶⁹ *Id.* See generally Bryson, *Proper Reporting Of Income Earned Between Effective Date And Closing Date Of Purchase Agreement*, 21 PETROLEUM ACCT. AND FIN. MGMT. J. 3 (Fall 2002).

⁷⁰ I.R.C. § 483(c)(1), Treas. Reg. § 1.483-4. Obligation to pay a purchase price adjustment is not a debt instrument because there is no sum certain or fixed maturity date.

⁷¹ *Cf.* I.R.C. § 108(e)(5) (purchase money debt reduction treated as a purchase price adjustment).

⁷² Rev. Rul. 55-675, 1955-2 C.B. 567 (assumed contingent liabilities taken into account in purchaser's basis when they become fixed and absolute); T.D. 9158, 69 Fed. Reg. 55740 (Sep. 15, 2004) (implying that Buyer does not take assumed liabilities into account in basis until economic performance (generally meaning payment) occurs with respect to the assumed liability). See the discussion of assumed liabilities above under the heading "Assumed Liabilities."

Whether Seller recognizes the Buyer's payment of the assumed liabilities as a purchase price adjustment depends on whether Seller took the assumption into account in Seller's amount realized at the time of sale. If Seller included the value of the Buyer's assumption of a Seller liability in Seller's amount realized at the time of sale, the transaction is closed as to Seller, and Buyer's subsequent payment of the liability generally should not have any tax effect on Seller. If Buyer's assumption of the liability was not taken into account at the time of sale but is instead taken into account upon Buyer's settlement of the liability (e.g., an assumed contingent liability the value of which could not be reasonably ascertained as of the closing date), Seller would be required to take Buyer's settlement of the liability into account at the time of settlement. In most cases, Buyer's settlement of the liability will not have any impact on Seller because Buyer's payment is treated as additional purchase price and as an offsetting payment of the liability by Seller. For this reason, and because Seller may not have information regarding Seller's settlement of the liability, Seller generally ignores Buyer's settlement of the liability.⁷³

Indemnity Payments

If Seller is required pursuant to the purchase and sale agreement to make a payment to Buyer due to a breach of a representation or warranty related to the value of the acquired assets, Seller's payment is generally treated as a reduction in Buyer's purchase price, and a reduction in Seller's amount realized.⁷⁴

If Seller's indemnity payment relates to a liability or expense incurred by Buyer and attributable to periods before closing, Buyer may be viewed as first assuming the liability, resulting in an increase in Buyer's purchase price for the acquired assets, an increase in Seller's amount realized, and a deemed payment of the liability or expense by Seller. After these effects are taken into account, Buyer's receipt of the Seller indemnity payment reduces Buyer's purchase price for the acquired assets (resulting in no net tax effect to Buyer),⁷⁵ and Seller's payment of the indemnity amount offsets the incremental

⁷³ One item of uncertainty is whether Buyer and Seller must recognize any imputed interest with respect to Buyer's settlement of an assumed contingent liability. To the extent the settlement is treated as a deemed deferred payment of purchase price, it would seem that a portion of the deemed payment should be treated as imputed interest. See Treas. Reg. § 1.483-4 (contingent payments characterized as principal and interest according to contingent payment debt rules in Treas. Reg. § 1.1275-4(c), but recognized according to Seller's regular method of accounting). However, there is authority for not imputing interest with respect to assumed contingent liabilities. *Tribune Publishing Company v. United States*, 836 F.2d 1176 (9th Cir. 1988) (no imputed interest on payment of contingent liability inherited in a merger transaction).

⁷⁴ *Shannonhouse v. Commissioner*, 21 T.C. 422 (1949) (Seller payments to Buyer for title defects in property sold constitute capital losses); *Boothe v. Commissioner*, 768 F.2d 1140 (9th Cir. 1985) (same). Cf. *Arrowsmith v. Commissioner*, 344 U.S. 6 (1952) (shareholder's payment of liquidated corporation's liability represented a reduction in the proceeds of the liquidation).

⁷⁵ Field Service Adv. 200048009 (Dec. 4, 2000). Alternatively, it might be appropriate to view Buyer's liability or expense as an impairment of capital, and the Seller indemnity payment as a non-taxable recovery of capital. See Ltr. Rul. 8748072 (Sep. 3, 1987) (indemnity for federal income taxes paid by taxpayer on bonds that were erroneously represented to be tax free). But see Lawrence Zelenak, *The Taxation of Tax Indemnity Payments: Recovery of Capital and The Contours of Gross Income*, 46 Tax L. Rev. 381 (Spring 1991) (arguing that the indemnity payment in Ltr. Rul. 8748072 should have been treated

amount realized from Buyer's deemed assumption of the liability (generally resulting in an overall net deduction for Seller). Alternatively, it may be proper to treat the Seller indemnity payments as payments of a retained liability having no tax consequences to Buyer (particularly where Seller pays the liability directly rather than Buyer paying the liability and being indemnified by Seller) and as a deduction to Seller.⁷⁶

To the extent the indemnified item is not attributable to periods before the closing (for example, fees and costs incurred by Buyer after closing, or interest accruing post-closing), the tax treatment is less clear. The IRS has ruled in the context of a deemed asset sale transaction that Buyer deducts the payment of the indemnified items and treats the receipt of the Seller indemnity payment as a reduction in Buyer's basis for the purchased assets.⁷⁷ The Seller presumably would be required under this theory to treat the indemnity payment as a reduction in Seller's amount realized (i.e., a capital loss in the year of payment if paid after the end of the tax year of the sale). An alternative view is that Buyer has no tax consequences associated with the indemnity payment, and Seller treats the payment as a selling expense (reduction in amount realized) or as a deductible retained liability or expense.⁷⁸

If a Seller indemnity payment is made by offset against amounts otherwise due to Seller under deferred payment arrangement, the reduction in payments due could impact imputed interest calculations for the deferred payments.

State Tax Issues

An asset sale transaction raises a number of state and local tax issues. Some of the more common issues arising with respect to an asset sale of a business are discussed in this section.

Transfer Taxes

Sellers and Buyers sometimes assume that there is a "bulk sale" exemption from sales and use taxes when the sale of assets occurs in the context of a sale of an operating business. This is generally incorrect. Moreover, where Seller is not a registered retailer under the applicable sales and use tax statute, Seller's sale of the assets to Buyer could

as taxable income to taxpayer (requiring a tax gross up) on the ground that the taxpayer did not pay more taxes than he owed, and further arguing that an indemnity payment designed to compensate the taxpayer for the diminished value of the bonds due to their taxable status would be a non-taxable reduction in the taxpayer's basis for the bonds).

⁷⁶ *Flood v. United States*, 133 F.2d 173 (1st Cir. 1943) (former partners could deduct retained pension liability payments after selling their former partnership's assets). Cf. Rev. Rul. 75-154, 1975-1 C.B. 186 (former partners could deduct retirement payments to a retired former partner after the termination and liquidation of their former partnership).

⁷⁷ Field Service Adv. 200048009 (Dec. 4, 2000).

⁷⁸ As a practical matter, it is likely that Buyer will treat the payment of the indemnified expense and the receipt of the Seller indemnity payment as offsets, and that Seller will simply deduct the indemnity payment as an operating expense.

give rise to the need to register and pay taxes. Accordingly, the parties must carefully consider the possible application of state sales and use taxes or other asset transfer taxes to the assets transferred to Buyer in the asset purchase and sale transaction. Most assets should be eligible for an exemption, as noted below:

- *Inventory*: Seller's sale of inventory items to Buyer is generally eligible for a sale for resale exemption.⁷⁹ Seller might have to obtain a resale exemption certificate from Buyer to perfect the exemption.
- *Vehicles*: Buyer is generally required to pay tax on vehicles acquired from Seller when Buyer registers the title to the vehicles in Buyer's name.⁸⁰
- *Other tangible personal property*: Other tangible personal property, such as operating equipment, will generally qualify for an occasional sale exemption. In Texas, the occasional sale exemption is available 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 ..." ⁸¹ and the assets are sold in a single transaction to a single purchaser.⁸² If Seller sells its assets to multiple buyers, or retains some operating assets, the sale of other tangible personal property may not qualify for the occasional sale exemption under Texas law.⁸³ In Texas, a special exemption is provided for property to be used for offshore or out of state exploration or production of minerals.⁸⁴
- *Real estate*: Some states may impose a transfer tax on the sale of real estate (including oil wells and items permanently affixed to the wells or other real estate). Texas does not have such a tax.
- *Intangibles*: Intangible property is generally not subject to state sales and use taxes. The tangible or intangible status of some types of property (such as computer software, maps and drawings, and similar intangible property stored in physical form) may require special attention.

⁷⁹ See, e.g., Tex. Tax Code § 151.054(b).

⁸⁰ See, e.g., Tex. Tax Code § 152.021.

⁸¹ Tex. Tax Code § 151.304(b)(2). Buyer may request that Seller certify that the transaction is exempt from sales and use taxes using Tex. Comptroller of Pub. Acct., Form 01-917 – Statement of Occasional Sale. See Tex. Ltr. Rul. 200711090L (Nov. 14, 2007) (noting that filing of the form is not mandatory).

⁸² Tex. Admin. Code § 3.316(d)(4).

⁸³ The occasional sale exemption also applies to the sale by a person, not in the business of selling, leasing, or renting taxable items and not holding a sales or use tax permit, of a taxable item if the person makes no more than two sales of a taxable items in a 12-month period. Tex. Tax Code § 151.304(b)(1); Tex. Admin. Code § 3.316(b).

⁸⁴ Tex. Tax Code § 151.324; Tex. Admin. Code § 3.332.

Withholding Taxes

States often have a statute providing that Buyer must withhold any unpaid Seller taxes from the purchase consideration for Seller's assets, and providing that Buyer is liable for any Seller taxes if Buyer fails to so withhold.⁸⁵ In most states, Buyer can request that the state issue a certificate of any tax due from Seller in advance of the closing so that Buyer knows the amount of its withholding obligation. Even if a certificate is obtained, Buyer may be exposed for tax liabilities arising between the date that the certificate is issued (or the date referenced in the certificate) and the closing date. Some states (including Texas) may allow for informal phone inquiries on or shortly before the closing date to determine whether any new liabilities have been posted since the certificate date.

If Seller has operations in many states, the process of obtaining tax clearance certificates can be cumbersome. Buyer might agree to limit its inquiries into the states where material liabilities are a concern, and rely on a Seller indemnification for other states. Also, Seller might wish to limit Buyer's inquiries in circumstances where such an inquiry might interfere with or trigger an examination by the applicable tax authority.

Texas Franchise Tax Considerations

Texas, like many other states imposing an income tax, measures Seller's taxable income (margin) by apportioning Seller's income from all sources to Texas based on the ratio of Seller's gross receipts from sources within Texas to Seller's gross receipts from all sources.⁸⁶ For this purpose, Texas and other states generally source gain from the sale of tangible assets (equipment, land, buildings, etc.) to the location of the property.⁸⁷ Most states source gain from the sale of intangible assets to Seller's commercial domicile.⁸⁸ But Texas has a unique rule (the so-called "location of the payor" rule) that sources Seller's gain on the sale of intangible assets to the Buyer's legal domicile.⁸⁹ Under the basic transaction structure described above, by forming Buyer as a non-Texas entity rather than under Texas law, Seller's gain on the sale of intangible assets is treated as non-Texas source income, thereby generally diminishing Seller's Texas franchise tax for the year of sale.

Seller may be able to further reduce its Texas franchise tax by contributing the assets to be sold to an LLC in advance of the sale, and then selling the membership interests in the company to Buyer. In this structure, Seller's entire gain is from the sale

⁸⁵ See, e.g., Tex. Tax Code § 111.020; Tex. Admin. Code § 3.7.

⁸⁶ Tex. Tax Code § 171.106.

⁸⁷ See, e.g., Tex. Admin. Code § 3.591(e)(23), (29)(A).

⁸⁸ Uniform Division of Income for Tax Purposes Act § 6(c), 7 Uniform Laws Annot. 331 (1985, Supp. 1997); Hellerstein & Hellerstein, *State Taxation* ¶ 9.03 (3d ed. 2009).

⁸⁹ Tex. Admin. Code § 3.591(e)(21)(B), (b)(8). Under the applicable Texas franchise tax rules, Buyer's legal domicile is its state of formation if Buyer is a corporation or LLC, or its principal place of business if Buyer is a partnership, trust, or joint venture. Tex. Admin. Code § 3.591(b)(7).

of intangible assets (LLC membership interests) and should be sourced outside Texas (assuming Buyer's legal domicile is outside Texas for franchise tax purposes).

If Seller's gain from the sale of its assets is primarily attributable to real property, and if the gain on the sale of real property (plus any other passive income for the year of sale) represents at least 90% of Seller's federal gross income for the year of sale, Seller may be able to qualify as a non-taxable passive entity for the year of sale.⁹⁰ This is only a benefit to the extent (a) Seller is organized as a partnership under state law at the time of sale,⁹¹ and (b) Seller's owners are individuals or non-taxable entities.⁹²

To the extent Seller has deferred recognition of gain from the sale under the installment method or by virtue of receiving Buyer equity in the transaction, Seller should consider distributing any installment obligations or equity that it received in the sale to Seller's owners who are individuals.⁹³ This will avoid Seller being subject to Texas franchise tax on receipt of payments with respect to the installment obligation or retained equity.

Taxable Purchase of Stock (Equity)

In some cases it is not feasible or desirable for Buyer to purchase the assets of the business to be acquired (e.g., because certain rights are not transferrable by the entity conducting the business). In those cases, the parties might structure the transaction as a taxable purchase and sale of the stock (or other equity ownership interests) in the entity that is conducting the business to be acquired (Target). The discussion below considers the tax consequences and considerations relevant to three types of target entities: a partnership (including an LLC classified as a partnership for tax purposes), an S corporation, and a C corporation. Note that under all of these transaction structures, Buyer is acquiring the business subject to all of Target's historical liabilities. Unlike in an asset purchase transaction, where Buyer can generally pick and chose the liabilities it will assume in the transaction, in a stock (equity) purchase transaction all of Target's liabilities remain with the company (unless Target can obtain a release of the liabilities).

⁹⁰ Tex. Tax Code § 171.0003(a)(2)(C).

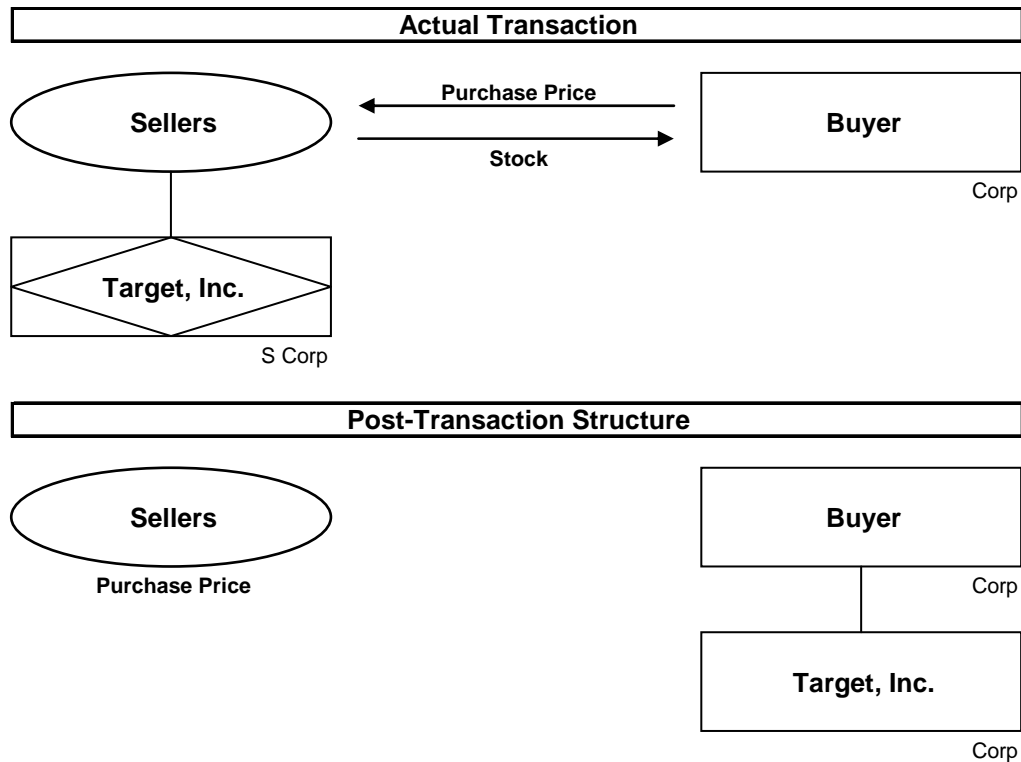
⁹¹ It should be possible to convert Seller to a partnership immediately prior to sale.

⁹² To the extent a Seller owner is a taxable entity, that owner's allocable share of Seller's income would potentially be subject to tax in the hands of the owner, unless the owner qualified as a passive entity. Therefore, while Seller can qualify as a passive entity without regard to the mix of its owners, Seller's status as a passive entity is of value only to owners who are not subject to Texas franchise tax on their allocable share of Seller's passive income.

⁹³ I.R.C. §§ 453(h), 453B(h) (no gain on distribution of installment obligation in complete liquidation of S corporation).

Partnership Target

Transaction Structure



In the transaction depicted above, Buyer acquires all of the outstanding equity interests in Target, and Target becomes a wholly owned subsidiary of Buyer. From Sellers' perspective the transaction is treated as a sale of partnership interests. From Buyer's perspective, the transaction is treated as a deemed liquidation of Target in which Target distributes all of its assets to Sellers, subject to all of Target's liabilities, in undivided interests proportionate to the ownership interest in Target, followed by Buyer's purchase of the assets and assumption of the liabilities from Sellers.⁹⁴

Seller Tax Considerations

As noted above, Sellers are viewed as having sold their Target equity interests to Buyer. Each Seller will recognize gain or loss to Buyer in an amount equal to the difference between the amount realized by the Seller for its Target equity (excluding any amounts realized attributable to Target's "hot assets" as discussed below) and the Seller's adjusted tax basis for the equity. Seller's adjusted basis for the Target equity is increased (or decreased) to take into account Seller's share of Target tax items for the portion of the

⁹⁴ Rev. Rul. 99-6, 1999-1 C.B. 432 (Situation 2).

taxable year ending on the date of the sale.⁹⁵ Seller's amount realized includes any reduction in Seller's share of Target liabilities.⁹⁶

Each Seller's gain or loss recognized on the sale of their Target equity to Buyer is generally classified as capital gain or loss.⁹⁷ However, the portion of the amount realized on the sale that is attributable to Seller's share of Target's unrealized receivables and inventory items (so-called "hot assets") is treated as ordinary income.⁹⁸ Hot assets include cash basis receivables, certain depreciation and amortization recapture, recapture of intangible drilling costs and depletion on section 1254 property, gain in inventory, and other similar items (generally, items that would constitute ordinary income if Target sold its assets).⁹⁹ Note that the amount of ordinary income realized by Seller is not limited to the amount of the gain on the transaction, and it is possible for Seller to recognize an overall gain on the transaction, but comprised of ordinary income and a capital loss that net out to the amount of the overall gain. Seller must file a statement with Seller's tax return for the year of the sale indicating the amount of gain or loss attributable to hot assets (section 751 property) and the amount of gain or loss attributable to capital gain or loss on the sale.¹⁰⁰

Buyer Tax Considerations

Because Buyer's purchase of all of the partnership interests in Target is treated as a deemed purchase of Target's assets and assumption of Target's liabilities, Buyer obtains a stepped up tax basis and fresh start holding period for each of Target's assets. Buyer's tax considerations are generally the same as Buyer's tax considerations for an actual purchase and sale of assets (discussed above). However, for state law purposes (including state law statutes regarding survival of tax liabilities) Buyer is generally treated as purchasing Target's equity. Therefore, Target's tax liabilities (if any) remain with Target after the transaction.

Retained Equity

If the transaction structure is modified so that Sellers retain a portion of their equity in Target, Target will have more than one owner after the acquisition.

⁹⁵ Treas. Reg. § 1.705-1(a)(1).

⁹⁶ Treas. Reg. § 1.1001-2(a)(1), (a)(4)(v) (amount realized on disposition of a partnership interest includes the transferor's share of partnership liabilities); I.R.C. § 752(d). For this purpose, cash basis payables are not included in Target's liabilities. Treas. Reg. § 1.752-1(a)(4).

⁹⁷ I.R.C. § 741.

⁹⁸ I.R.C. § 751(a).

⁹⁹ I.R.C. § 751(c), (d).

¹⁰⁰ Treas. Reg. § 1.751-1(a)(3). See also Treas. Reg. § 1.1(h)-1(e) (reporting for Section 1250 recapture) and IRS Instructions to Schedule D (Form 1040) p. D-8 (same). Target is required to file IRS Form 8308, *Report of Sale or Exchange of Certain Partnership Interests*, with its tax return and provide a copy to Seller and Buyer. The Form 8308 is intended to alert the Seller of the need to file the required statement under Treas. Reg. § 1.751-1(a)(3).

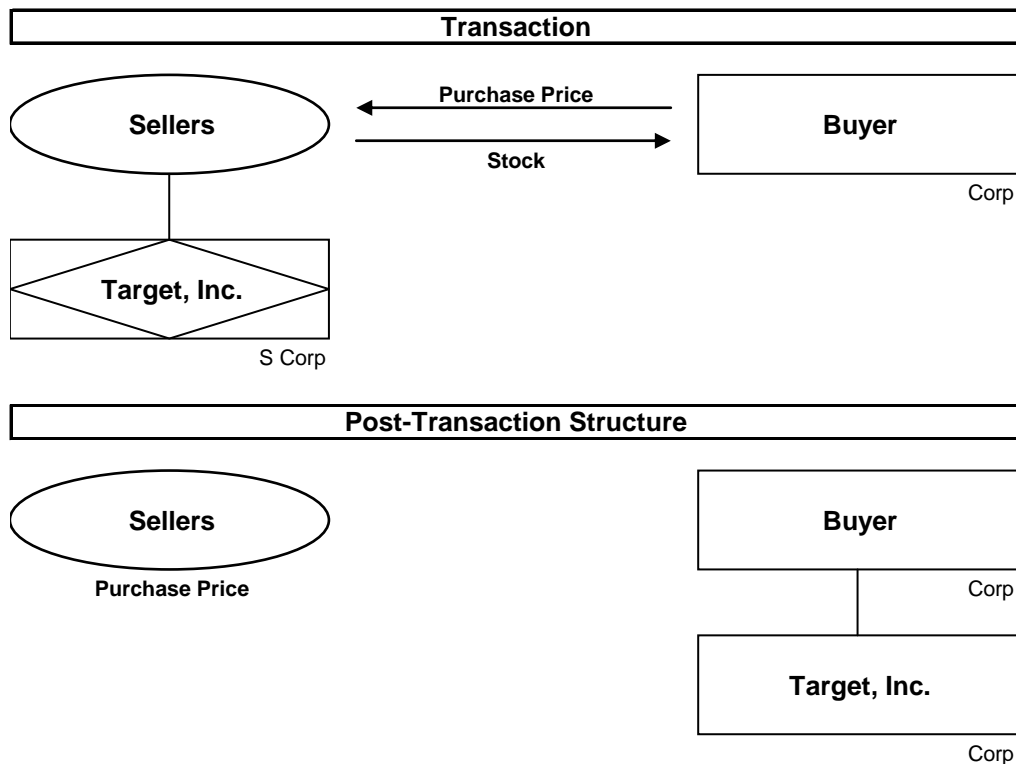
Consequently, Target is not treated as a disregarded entity after the transaction. Instead, it is treated as a partnership, and Buyer is viewed as purchasing partnership interests from Sellers (consistent with the legal form of the transaction). Although Buyer is viewed as purchasing Target equity rather than Target assets, Buyer can generally obtain a stepped up tax basis for the portion of Target's assets attributable to Buyer's equity interest in Target simply by causing Target to file "section 754" election.¹⁰¹ The effect of the election is to adjust the tax basis of Target's assets only with respect to Buyer's interest in those assets. The tax basis of Target's assets is not adjusted with respect to Sellers' retained equity interest, and Sellers' are not taxable on the retained equity interest.

The rule allowing a proportionate step up in the tax basis of Target's assets with respect to the equity interest purchased by Buyer is not dependent on the percentage interest purchased by Buyer or retained by Sellers. Buyer can purchase anywhere between 0% to 100% and obtain a stepped up tax basis for the percentage interest purchased, while Seller defers tax on the interest retained. This is not the case with a 338(h)(10) election (discussed below) for a Target corporation. A 338(h)(10) election requires a purchase of at least 80% of vote and value of Target's stock, and once the 80% threshold is reached and a 338(h)(10) election is made, Sellers are fully taxable on the transaction, even on retained stock.

¹⁰¹ I.R.C. §§ 743(b), 754. The election is made on Target's tax return for the period that includes the closing date for the transaction. Treas. Reg. § 1.708-1(b)(5).

S Corporation Target

Transaction Structure



In this transaction, Buyer purchases all of the stock of Target (an S corporation) and Target becomes a subsidiary of Buyer.¹⁰²

Target's S corporation election terminates as of the end of the purchase date,¹⁰³ and Target can join in a consolidated return with Buyer effective as of the day after the

¹⁰² If Target's stock is widely held and a purchase of stock from each shareholder would be cumbersome or otherwise problematic, the stock purchase can be effected by means of a reverse subsidiary merger. In such a transaction, Buyer forms a transitory subsidiary that merges into Target with Target as the sole surviving entity in the merger. Under the terms of the merger agreement, all of Target's previously outstanding stock is cancelled in exchange for the purchase price, and Buyer becomes the owner of all of Target's stock. The net effect of the transaction is the same as the purchase of Target's stock by Buyer, and the merger transaction is treated for tax purposes as a deemed purchase of stock. Rev. Rul. 73-427, 1973-2 C.B. 301; Rev. Rul. 79-273, 1979-2 C.B. 125; Rev. Rul. 90-95, 1990-2 C.B. 67.

¹⁰³ I.R.C. § 1362(d)(2)(B) provides that Target ceases to be an S corporation "on and after" the date it ceases to qualify as an S corporation. For this purpose, Sellers should be treated as owning Target's stock through the end of the acquisition date, and therefore Target should cease to be an S corporation on the day following the acquisition date. Treas. Reg. § 1.1377-1(a)(2); -1(c) Ex. 2. Ltr. Rul. 7904002 (target becomes a member of buyer's consolidated group the day after the closing). Cf. *Anderson v. Commissioner*, T.C. Memo 1974-49 (stock purchaser's holding period begins on the day following the purchase date); Rev. Rul. 70-598, 1970-2 C.B. 168 (same).

purchase date.¹⁰⁴ Absent any election under I.R.C. § 338 (discussed below), Target's adjusted tax basis for its assets as of the purchase date will carryover into Buyer's consolidated tax return without any adjustment. Accordingly, Buyer's tax basis in its stock of Target (outside basis) could exceed Target's tax basis in its assets (inside basis). Buyer's ability to obtain a tax benefit for the excess outside tax basis can be restricted.¹⁰⁵ Sellers generally recognize solely capital gain or loss with respect to the sale of their Target stock, subject to possible Section 1254 recapture.¹⁰⁶

Under certain circumstances, Buyer can make an election under I.R.C. § 338 to obtain a tax basis for Target's assets equal to the deemed purchase price of the assets, generally with minimal tax detriment to Sellers. To qualify for the election, Buyer must be a corporation and must purchase at least 80% of the total voting power and total value of the Target stock.¹⁰⁷ If the election is made, Target (referred to as "Old T") is treated as having sold all of its assets to a hypothetical Buyer subsidiary (referred to as "New T") as of the close of the acquisition date for consideration that includes New T's assumption of Old T's liabilities, and New T is treated as having purchased the assets as of the beginning of the day following the acquisition date for consideration that includes assumption of Old T's liabilities.¹⁰⁸

There are two types of elections under I.R.C. § 338: a 338(g) election (or "regular" 338 election); and a 338(h)(10) election. A regular election is rarely advisable because the effect is to cause Sellers to recognize gain or loss on the sale of their Target stock and also cause Target to recognize gain or loss on the deemed sale of its assets. If the deemed asset sale produces a gain, Buyer effectively pays the tax on the deemed asset sale because New T is liable for the tax on the deemed asset sale, and therefore the tax is effectively an assumed liability.¹⁰⁹ If the deemed asset sale produces a loss, Target may have limited ability to use the loss to offset other income. A 338(g) election generally makes sense only if Target has significant net operating loss carryforwards to shelter the deemed asset sale gain, or minimal gain or loss in its assets, or other special circumstances exist.

The much more common election is a 338(h)(10) election, which is available only where the requirements for a regular election exist (i.e., Buyer is a corporation and Buyer

¹⁰⁴ Treas. Reg. § 1.1502-76(b)(1)(ii)(A)(2) ("If [a corporation ("S")] becomes a member in a transaction other than in a qualified stock purchase for which an election under section 338(g) is made, and immediately before becoming a member an election under section 1362(a) was in effect, then S will become a member at the beginning of the day the termination of its S corporation election is effective. S's tax year ends for all Federal income tax purposes at the end of the preceding day.").

¹⁰⁵ See Treas. Reg. § 1.1502-36.

¹⁰⁶ See I.R.C. § 1254(b)(2) (discussed below).

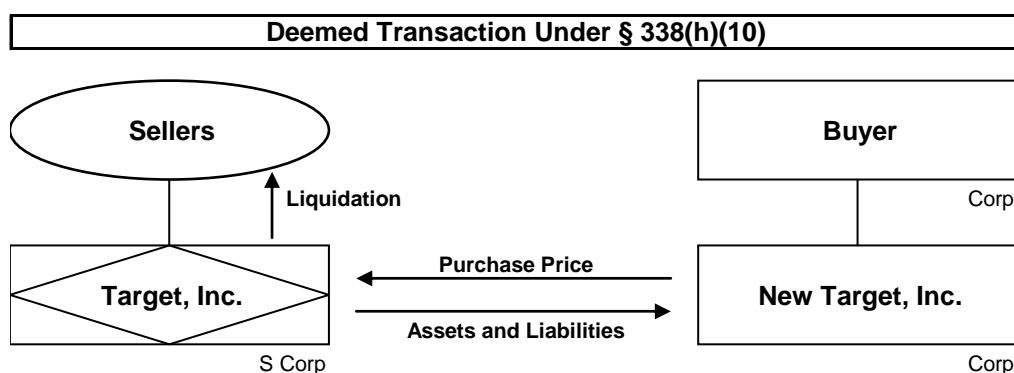
¹⁰⁷ I.R.C. § 338(a), (d)(3).

¹⁰⁸ Treas. Reg. § 1.338-1(a)(1).

¹⁰⁹ Treas. Reg. § 1.338-10(a)(3) (deemed asset sale is reported by Target on a C corporation return); Treas. Reg. § 1.338-1(b)(3)(i) (New T is liable for Old T's tax liabilities, including Old T's tax liability with respect to the deemed asset sale).

acquires at least 80% of Target's stock by vote and value), and in addition Target is a subsidiary member of a consolidated group, a non-consolidated affiliate of a Seller corporation, or an S corporation. In those circumstances, the effect of a 338(h)(10) election is a deemed sale of assets by Old T to New T as described above, with the added qualifications that (a) Sellers do not recognize any gain or loss on the sale of their Target stock to Buyer, and (b) Old T is deemed to liquidate immediately after the deemed sale of its assets.¹¹⁰

The deemed asset sale transaction resulting from a 338(h)(10) election can be illustrated as follows:



Seller Tax Considerations

As noted above, if Sellers do not join with Buyer in making a 338(h)(10) election, Sellers' gain recognized on the transaction will generally qualify as solely long-term capital gain (assuming Sellers have held the Target stock for more than one year). A significant exception is recapture of intangible drilling costs and depletion deductions under I.R.C. § 1254. Under this exception, Sellers' gain with respect to the sale of Target stock is treated as ordinary income to the extent of Seller's "section 1254 costs" with respect to the shares sold.¹¹¹ Section 1254 costs include intangible drilling costs that would be capitalized but for the deduction in I.R.C. § 263(c), and depletion deductions that result in a reduction in the adjusted tax basis for the affected property.¹¹²

Another potentially significant exception to Seller recognizing capital gain on the sale of the shares of an S corporation is the collapsible corporation rules in I.R.C. § 341, which treat the entire gain from the sale of stock in a collapsible corporation as ordinary income.¹¹³ These rules were repealed in 2003, but are scheduled to become effective

¹¹⁰ Treas. Reg. § 1.338(h)(10)-1(d). The regulation further provides that Target's status as an S corporation continues through the acquisition date. However, as discussed in footnote 105 above, that conclusion should apply in any event.

¹¹¹ I.R.C. § 1254(b)(2); Treas. Reg. § 1.1254-4(c)(1). An exception is provided where the shareholder can establish that a portion of the gain recognized on the sale of the S corporation stock is not attributable to section 1254 costs.

¹¹² Treas. Reg. § 1.1254-1(b)(1)(i).

¹¹³ Treas. Reg. § 1.341-1.

again for tax years beginning in 2011.¹¹⁴ Absent Congressional action to extend the repeal, the collapsible corporation rules will again serve as a trap for the unwary who may unknowingly recognize ordinary income on the sale of the stock of a corporation that conducts oil and gas production activities.¹¹⁵

If the parties make a 338(h)(10) election, Sellers are allocated their share of Target's gains and losses on the deemed sale of its assets. To the extent Target owns assets that generate significant ordinary income (other than section 1254 costs), Sellers' tax on the deemed sale of Target's assets could exceed Sellers' tax on a sale of Target stock with no 338(h)(10) election.¹¹⁶ Sellers sometimes request that Buyer compensate Sellers for the incremental tax. Note that if the collapsible corporation rules in I.R.C. § 341 (discussed above) come back into effect, a 338(h)(10) election would take the transaction outside the application of those rules.

Buyer Tax Considerations

A significant concern for a Buyer purchasing the stock of an S corporation is whether Target has validly elected and maintained its S corporation status for all open tax years. The requirements for electing and maintaining S corporation status are very specific and it is not unusual for Target to have unknowingly breached these requirements. For example, if Target has issued profits based interests to shareholders, lenders, or service providers, the interests could be deemed to be a second class of stock and could cause Target to be in violation of the one class of stock requirements.¹¹⁷ Another example is if an ownership interest in Target stock has vested in a non-resident alien (e.g., through marriage of one of the shareholders)¹¹⁸ or in a person who is not a qualified shareholder.¹¹⁹

If Target's S corporation status is not valid or was terminated prior to sale, any 338(h)(10) election is invalid, and Buyer will not obtain a step up in the tax basis of

¹¹⁴ Pub. L. No. 108-27 §§ 302(e)(4)(A), 303 (2003); Pub. L. No. 109-222, § 102 (2005). The collapsible corporation rules were originally enacted to shut down schemes in which movies were produced by transitory corporations that were liquidated just prior to the commercial release of the movie, with the result that the shareholders recognized capital gain and a stepped up tax basis on the liquidation of the corporation, thereby effectively converting what would have been ordinary income in the hands of the corporation into capital gain in the hands of the shareholders. A key to this scheme was the ability of the corporation to liquidate tax free under I.R.C. § 337 and the *General Utilities* doctrine. The repeal of this doctrine in 1986 rendered the collapsible corporation rules obsolete as a policy matter.

¹¹⁵ See Rev. Rul. 57-346, 1957-2 C.B. 236; Rev. Rul. 64-125, 1964-1 (Part 1) C.B. 131.

¹¹⁶ One potentially material incremental tax item is Texas franchise tax. The deemed asset sale transaction could create taxable margin and Texas sourced receipts, causing an increase in Texas franchise tax that would not arise on a sale of stock with no 338(h)(10) election. Tex. Tax Code § 171.1011(c)(1)(A); Tex. Admin. Code § 3.591(e)(7). For businesses that carry significant inventory, LIFO recapture can be another significant difference.

¹¹⁷ I.R.C. § 1361(b)(1)(D).

¹¹⁸ I.R.C. § 1361(b)(1)(C).

¹¹⁹ I.R.C. § 1361(b)(1)(B).

Target's assets. Of even more concern is the fact that Target is liable for unpaid corporate taxes for all open tax periods. While the purchase agreement will generally require Sellers to indemnify Buyer against Target taxes and other consequences of an invalid or terminated S corporation election, Buyer may have difficulty recovering on the indemnity.

A similar concern arises with respect to unpaid Target corporate taxes under I.R.C. § 1374 (built-in gains) and I.R.C. § 1375 (excess passive income). If Target is liable for any such taxes, Buyer will effectively inherit those liabilities as Target's new owner. Again, Seller will generally indemnify Buyer against any such Target taxes, but recovery on the indemnity may be problematic.

Because of these concerns, Buyer should consider whether an actual purchase of assets or a divisive merger (as discussed in the previous section) is preferable to a purchase of stock with a 338(h)(10) election. Another option is to reorganize Target so that it is a qualified subchapter S subsidiary of a newly formed holding company (Newco) that elects S corporation status. The imposition of the holding company structure should be tax free, with Newco treated as the successor in interest to Target and Target treated as a disregarded entity.¹²⁰ Newco's sale of Target's stock to Buyer should be treated for federal income tax purposes as a sale of Newco's assets with Newco retaining any tax liability under I.R.C. §§ 1374 and 1375. Note, however, that the reorganization does not relieve Target of liability for corporate level taxes if Target's S corporation election is invalid or has been terminated.¹²¹

Retained Equity

If the transaction is structured so that Sellers retain an equity interest in Target, the tax consequences depend on the size of the ownership interest retained. If Buyer purchases less than 80% of Target's stock, the transaction no longer qualifies for a 338(h)(10) election. The transaction then has the potentially undesirable consequences mentioned above for a stock purchase without a 338(h)(10) election (i.e., no step up in the tax basis of Target's assets). In such a case, the parties might find it desirable to restructure the transaction as a taxable purchase of assets by Target to Buyer (or a Buyer subsidiary) in which Target takes back an equity interest in the Buyer or its subsidiary. The tax consequences of such a transaction are generally as described above for a taxable purchase of assets.

¹²⁰ I.R.C. § 368(a)(1)(F). *See also* Rev. Rul. 2008-18, 2008-18 I.R.B. 674 (Target treated as a separate entity for employment tax and excise tax purposes).

¹²¹ If Target is, after the insertion of Newco as the holding company, converted to an LLC prior to sale, the conversion to an LLC would be treated as a deemed liquidation of Target if Target were held to be a C corporation prior to the conversion. It appears that any liability for C corporation federal income taxes owed by Target would pass to Newco in the liquidation. This may be an effective means for Buyer to purchase equity of Target without inheriting Target's contingent liability for C corporation taxes. However, there is some risk that the IRS would claim that the contingent liability remains with Target as a matter of state law.

If Sellers will retain a 20% or less interest in Target, the transaction will qualify for a 338(h)(10) election, but the election will require all shareholders to recognize gain on all of their Target stock. The price for Target getting a step up in the tax basis of all of its assets under 338(h)(10) is that the shareholders must recognize all of the gain embedded in their stock, even the stock that is retained.

In comparison, a partnership target (including an LLC classified as a partnership for tax purposes) is more flexible because there is no 20% limit on retained equity, and Sellers recognize gain only to the extent of the portion of their equity sold to Buyer. The trade off is Buyer gets a stepped up tax basis only to the extent of the percentage interest acquired.

C Corporation Target

Transaction Structure

The transaction structure for the sale of a C corporation is the same as the transaction structure for the sale of an S corporation. See the diagram under the above section titled “S Corporation Target.” Because Target is a C corporation, a 338(h)(10) election is available only if Target is a subsidiary member of a consolidated group or a non-consolidated affiliate of a Seller corporation.¹²² If Target is owned by individuals, a 338(h)(10) election is not available¹²³ and a 338(g) election would have the adverse tax consequences described above (i.e., tax on the sale of stock and tax on the deemed sale of assets).

Seller Considerations

If Seller is an individual shareholder of Target C corporation, Seller generally faces the undesirable position of not being able to economically offer Buyer a stepped up tax basis for Target’s assets, and as a result, Buyer’s price for Seller’s stock may be discounted to take into account Buyer’s reduced tax benefits post-acquisition.¹²⁴ There are no silver bullets for solving this issue (other than making sure Seller doesn’t use a C corporation for the business to begin with), but there are a number of strategies that might mitigate Sellers’ problem.

¹²² Treas. Reg. § 1.338(h)(10)-1(c).

¹²³ In theory, Target might be able to elect S corporation status for the year of sale and then qualify for a 338(h)(10) election. This will generally be of no value because the I.R.C. § 1374 tax on built-in gains will cause a corporate level tax on the deemed sale of Target’s assets (in addition to the flow through tax on the sale of the assets under I.R.C. § 1366).

¹²⁴ Investment bankers and other financial advisors frequently argue that a given business is valued based on a multiple of EBITDA or another pre-tax measure, and therefore Buyer’s loss of a stepped up tax basis does not adversely affect the valuation of Seller’s stock. This proposition seems dubious where Target is expected to be a fully taxable entity post-acquisition. Buyer is unlikely to completely ignore the additional cash tax expenses the business will incur as a result of not being able to amortize the premium paid for the business.

“Shareholder Goodwill,” Etc. Where Sellers own valuable assets used by Target in its business (e.g., customer or vendor relationships, reserve data, operational knowhow, etc.), it should be possible to have Buyer acquire those assets directly from Sellers (in addition to acquiring Seller’s stock of Target), resulting in a single level of tax to Sellers, and a stepped up tax basis to Buyer, for those assets.¹²⁵ Buyer can then contribute those assets to Target post-closing, and Target will inherit the stepped up tax basis. If the assets are in the nature of goodwill or other capital assets, Seller should recognize long-term capital gain on the sale.

A similar strategy is for Seller to enter into a consulting agreement with Buyer to provide services to Target following the acquisition, or for Seller to enter into a non-compete agreement. Buyer might reduce the purchase price for the business to account for the payments due under the consulting or non-compete agreements. Provided the amount paid for the consulting services or non-compete agreement is reasonable in relation to the services rendered or the competitive threat avoided, Seller is taxable directly on the amount received without any corporate level tax. Unfortunately, Buyer must amortize any payment for a covenant not to compete over 15 years,¹²⁶ even though Seller recognizes ordinary income with respect to amounts received for the consulting agreement or covenant.¹²⁷

S Corporation Election and Waiting Period. One strategy that is 100% effective, but is rarely feasible is to have Sellers elect S corporation status for Target (if they meet the requirements for doing so) and then wait to sell the assets until 10 years has expired or the built-in gain in Target’s assets at the date the S election has dissipated, whichever is earlier. The waiting period is necessary to avoid the I.R.C. § 1374 tax on S corporation built-in gains. This tax is applied on an asset-by-asset basis to any gain realized by an S corporation on the sale of an asset held at the time it converted from a C corporation to an S corporation. The tax is imposed on the lesser of the built-in gain for the asset at the time of conversion or the gain actually recognized on the sale of the asset. For corporations whose value is exclusively or primarily attributable to goodwill, the waiting period is generally 10 years (because the IRS takes the view that the value of goodwill does not dissipate until the entire business is abandoned). For a corporation engaged in an oil and gas business and whose appreciated assets are primarily depleting properties, a shorter waiting period may be possible if the built-in gain at the date of conversion

¹²⁵ See *Martin Ice Cream v. Commissioner*, 110 T.C. 189 (1998); *Norwalk v. Commissioner*, T.C. Memo 1998-279.

¹²⁶ I.R.C. § 197(d)(1)(E).

¹²⁷ *Ullman v. Commissioner*, 264 F.2d 305 (2nd Cir. 1959) (“It is well established that an amount a purchaser pays to a seller for a covenant not to compete in connection with a sale of a business is ordinary income to the covenantor and an amortizable item for the covenantee unless the covenant is so closely related to a sale of good will that it fails to have any independent significance apart from merely assuring the effective transfer of that good will.”).

dissipates in less than 10 years.¹²⁸ However, even if the waiting period is less than 10 years, Seller may not want to wait even that long to sell the business.

Like-Kind Exchange and S Corporation Election. Target may be able to effect a sale of its assets to Buyer (or a Buyer subsidiary) in a tax-free like-kind exchange under I.R.C. § 1031. To qualify for tax free treatment, Target will have to invest the proceeds of the sale in qualified replacement property (generally other real estate or qualified natural resource recapture property).¹²⁹ Having done so, Target can then make an S corporation election, wait 10 years, and then sell the replacement property with only a single level of tax. To accommodate such a long-term holding of real estate assets while providing diversification and some measure of liquidity, a number of promoters have organized diversified portfolios of real estate assets through tenant-in-common structures to serve as replacement property investments for real estate dispositions and to provide for efficient borrowing against the replacement property. If Target wants to dispose of any replacement property before the 10-year waiting period, the I.R.C. § 1374 tax will apply only to the lesser of (a) the built-in gain on the date the S corporation election was effective, and (b) the actual gain realized. This is applied on an asset by asset basis.

Section 1202(a) Small Business Stock. If Target's stock qualifies as "qualified small business stock," a portion of the gain on the sale may qualify for exclusion from Seller's income. This exclusion is only available on the sale by an individual of stock of a C corporation that is a qualified small business (less than \$50,000,000 in assets) and other requirements specified in I.R.C. § 1202 are met.¹³⁰ The gain eligible for the exclusion in any taxable year is limited to the greater of \$10 million or ten times the taxpayer's original basis in the stock.¹³¹

Leveraged ESOP and Section 1042 Rollover. In a leveraged ESOP disposition, Buyer purchases a portion of Target's stock, and a newly formed employee stock ownership plan ("ESOP") owned by Target's employees purchases the remainder of Target's stock (at least 30%) using bank borrowings or other debt borrowed either directly or through Target. Contributions and dividends paid by Target to the ESOP to fund the debt service (or to fund the participants' accounts) are deductible by Target, and the ESOP is not taxed on the receipt of the contributions or dividends. Seller's gain on the sale of stock to the ESOP can be deferred to the extent Seller reinvests the proceeds of the sale in qualified replacement property (generally stock or debt of domestic

¹²⁸ Production and sale after the conversion date of oil reserves held on the conversion date is not treated as a recognized built-in gain. Treas. Reg. § 1.1374-4(a)(3), (b). The discussion in text assumes that actual economic depletion in the value of the property exceeds the depletion deductions claimed with respect to the property.

¹²⁹ See Browne, *supra* note 45, at 57.

¹³⁰ The Obama administration has proposed to increase the exclusion percentage for small business stock from 75% to 100%, and to eliminate the excluded gain as a preference item for alternative minimum tax purposes. See Dept. of the Treas., *General Explanations of the Administration's Fiscal Year 2011 Revenue Proposals* p. 24 (Feb. 2010).

¹³¹ I.R.C. § 1202(b).

operating corporations or mutual funds holding only such investments).¹³² It may be possible to structure the transaction as a sale of all of Target's stock to an ESOP combined with a post-acquisition S corporation election for Target to effectively cause Target to become a tax exempt entity. Buyer's investment is structured as debt with warrants or options, and is limited to an effective 50% ownership interest (with the remaining 50% ownership interest being held by the ESOP).¹³³

Leveraged partnership disposition. The leveraged partnership disposition strategy, and the similar partnership mixing bowl disposition strategy, were discussed in Part I of this article.¹³⁴ The idea would be for Target to contribute its assets to a partnership in a tax deferred disposition transaction. Target can then elect S corporation status and wait 10 years before disposing of its partnership interest. As in the case of the like-kind exchange strategy, if Target liquidates or disposes of its partnership interest before the 10-year waiting period under I.R.C. § 1374, the corporate tax will apply only to the lesser of (a) the built-in gain on the date the S corporation was effective, and (b) the actual gain realized.

Tax Free Reorganization. Buyer may be willing to structure the transaction as a tax-free reorganization, such as forward merger of Target into Buyer in which Sellers receive Buyer stock.¹³⁵ This will allow Sellers to defer gain on the Target stock that is exchanged for Buyer stock. The transaction only defers Seller's tax, and does not give Buyer a stepped up tax basis for Targets assets. Therefore, the transaction does not really address Seller's discount; it only defers Seller's tax liability until Seller disposes of the Buyer stock.

Charitable Remainder Trust. Seller might make a gift of all or a portion of the Target stock to a charitable remainder trust (CRT), retaining a life annuity. The CRT can then sell the Target stock without tax (because the CRT is a non-taxable entity). The CRT reinvests the proceeds in income producing assets which it uses to make the annuity payments to Seller. On Seller's death, the remaining trust assets pass to the charity.

Buyer Considerations

If the purchase price to be paid by Buyer for Target stock will be funded, in whole or in part, by having Target borrow against its assets and transfer the proceeds to Sellers, the transaction may be characterized as a deemed dividend to Buyer.¹³⁶ To avoid this

¹³² See generally Ginsburg & Levin, *Mergers, Acquisitions, and Buyouts* ¶1406 (July 2009).

¹³³ *Id.* ¶ 1102.2.1.

¹³⁴ Browne, *supra* note 45, at 64-66.

¹³⁵ I.R.C. § 368(a)(1)(A).

¹³⁶ See John F. Prusiecki, *Tax Aspects of Agreements for Taxable Acquisitions of Corporate Businesses*, 18 J. Corp. Tax'n (WG&L) 3 (Autumn 1991). In FSA 200117004 (Jan. 10, 2001), Buyer, a partnership, agreed to purchase stock of REIT. At closing, the purchase agreement was amended so that REIT borrowed money and redeemed a portion of its stock. Buyer then purchased the remainder of the stock for the agreed purchase price less the amount paid by the REIT in the redemption. The IRS held that the redemption is treated as a dividend to Buyer, and a payment by Buyer to Seller. In effect, Target loaned

problem, the stock purchase agreement must clearly state that the amount owed by Buyer for the purchase of Target stock is the stated purchase price minus the amount that Target will pay to Sellers, and that the issuance and/or refinancing of Target's debt is a condition to closing.

Conclusion

This article provides only a high level overview of some of the myriad tax issues that arise on a purchase and sale of an operating business. There are almost infinite alternative transaction structures and means and forms of transferring the acquired business to Buyer and consideration to Sellers.¹³⁷ The discussion above provides an introduction to some of the basic tax concepts that apply to common transaction structures and often come into play in alternative or more complicated transaction structures.

the money to Buyer so that Buyer could close the sale, then immediately following the closing Target forgave the loan as a dividend to Buyer.

¹³⁷ One significant category of transactions that is only briefly mentioned in this article is the various forms of tax-free reorganizations under I.R.C. § 368.