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Buying and Selling Businesses

2014 Edition

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Buying and Selling Businesses is published periodically by the law firm of Vedder Price. It is intended to keep our clients and interested parties generally informed about issues related to the purchase or sale of a business. It is not a substitute for professional advice. For purposes of the New York State Bar Rules, this publication may be considered ATTORNEY ADVERTISING. Prior results do not guarantee a similar outcome.

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Buying and Selling Businesses

The purchase or sale of a business is one of the most challenging activities a businessman or woman can undertake. The price and terms received by a seller represent the culmination of what may well be a lifetime's work in building the business. A purchaser may have expended a lifetime's savings or an equivalent in financing to acquire a business. A purchaser may be a corporate acquirer, whose acquisitions may well set the tone in determining the profitability of the overall corporate entity for many years to come.

The success or failure of an acquisition or divestiture is due in large part to the associated business decisions. However, a team of concerned professionals—investment bankers, accountants and attorneys—can have a substantial bearing on the success of the transaction as well.

Major corporate transactions such as these are inevitably complicated and move with a speed that does not permit on-the-job training for the professional team. Consequently, it is essential that the businessperson who undertakes such a transaction have a professional team in place that is experienced and equipped to handle the challenges involved.

The contributors to this booklet are all persons who have participated in buying and selling businesses and have contributed their particular experience and talents to the completion of many successful transactions. In that context, we hope you find the following chapters, touching on various aspects of such transactions, informative regarding the subject matter and our firm's involvement in such endeavors.

Chapter 1

Initial Steps

The Seller's Perspective

1. Reason for Sale

Businesses are sold for many reasons. A sole shareholder, a family or a small group of individuals who founded a business may have the bulk of his or their assets in the shares of a company. Sale of the business for cash or an exchange of equity for shares of a publicly traded company can satisfy many needs, such as a need to pay off personal creditors, diversify investments, provide for retirement, make funds available to pay estate taxes and provide for the owners' families, some of whom may be active in the business.

In other situations, there may be entrepreneurs who are good at starting companies but do not want to deal with or perhaps are unable to cope with the management burdens that come with an emerging or maturing company. A sale can provide the necessary exit vehicle and some immediate cash to allow the entrepreneur to start another company.

In some cases, businesses are sold in order to solve serious internal or external problems. If the shareholders of a closely held corporation cannot agree on certain major issues, and one faction is unable or unwilling to buy the other out, a sale to a third party may be the only solution. In some cases, changes in the marketplace, increased competition, rapidly changing technology or product obsolescence creates a need for capital that the owners cannot supply or obtain. A sale to a larger concern may be the answer.

Very early in the process, the seller must identify his own estate planning and wealth transfer objectives. Selling a business represents a "once in a lifetime" opportunity to reduce or possibly eliminate estate tax and gift tax liability. Ideally, this planning should occur well in advance of the decision to sell the business. Readers should consult Chapter 11 for crucial estate planning techniques available to the seller.

Finally, many businesses may be sold merely because the buyer made the seller an offer he could not refuse, and the seller recognized the advantages of joining with a larger, more successful organization.

Regardless of the seller's principal motivations for selling, he should make all of his reasons known to his professional team, since his desires will affect the negotiations and may require special attention.

2. Price

Numerous factors will affect the price to be paid, and the agreed-upon price may be paid in a variety of ways. Price will, of course, depend upon the relative bargaining strengths of the buyer and the seller. Further, price is affected by whether the buyer pays in cash, notes (and the interest rates charged by the seller) and/or other securities. Price can be affected by whether stock or assets are sold. The price for "the business" can also be affected if assets are excluded from the sale, such as real estate that may be retained by the seller and leased to the buyer. The seller may stay involved with the business and receive a salary, or the buyer may want the seller out of the business and any competing business and pay the seller a noncompete payment. If the payment to be paid by the buyer exceeds the fair market value of all of the seller's tangible assets, part of the payment may be allocated to such intangibles as patents, trademarks or goodwill. The price to be paid may be subject to certain post-closing adjustments, and/or some portion of the price may be contingent upon the acquired business's reaching certain financial goals. All of the factors mentioned have income tax attributes to make price one of the key terms of the transaction to be negotiated. Indeed, the net after-tax price should be the focus for both the buyer and the seller. Moreover, each party's perception of whether the agreed-upon price is a good or bad deal for it will likely affect subsequent negotiations.

Because of the complexities involved in negotiating price, it is imperative that a seller consult with his professional team before attempting to negotiate "the price."

3. Other Considerations

As indicated above, a seller may or may not want to continue in the employ of his business following a sale. This issue should be carefully considered at an early stage of the negotiations to allow for an orderly transition.

During the negotiation process, a seller must be concerned about the secrecy of the negotiations because an untimely information leak may cause a key employee of the seller to quit or may cause the seller to lose a big order from an important customer. Also, if the sale is not consummated, the seller may be viewed as "damaged goods" by the market. In short, sellers have more to lose here than buyers because an aborted deal can seriously harm a seller, while the buyer is free to pursue another target company.

During negotiations, the buyer will conduct due diligence, i.e., spend time investigating the present status and future prospects of the target company. Some of the investigation will take place at the premises of the target company and will include interviews of target company personnel and examination of target company books and records by the buyer, its accountants and other representatives. It is imperative that a confidentiality agreement be entered into between the buyer and the target company as early in the process as possible and prior to the disclosure of any confidential information by the seller or an on-site investigation by the buyer, and that the seller establish procedures for the conduct of the due diligence by the buyer. These measures will help minimize the risk of harm to the seller. It is recommended that the seller involve his professionals in the negotiation of the confidentiality agreement and the establishment of due diligence procedures.

Buyers must also examine their estate planning objectives in light of any proposed acquisition. The purchase of a business affords a marvelous opportunity to reduce estate and gift tax liability. Buyers are directed to relevant pages in Chapter 11 for the important planning techniques available to them.

The Buyer's Perspective

1. Reason for Purchase

The most often stated reasons for business acquisitions are that buyers want to diversify or expand their existing businesses. Frequently, a buyer wants to expand a product line or acquire desirable assets, such as a plant, patents, trademarks, trade names, cash, capital or management personnel. In other cases, buyers want to secure sources of supply or distribution channels.

In certain cases there are significant financial reasons for the acquisition, such as obtaining a higher rate of return on invested funds or increasing earnings per share of the buying company. Buying a public company can be a way for a private company to "go public" and to obtain the benefits of a public company.

A leveraged buyout, in which assets of the target company are used to collateralize a loan incurred to buy the target, and the target's cash flow is used to pay off the loan, may present an opportunity for management to purchase a significant equity interest in their employer.

2. Financing

Most buyers want to pay less and to use less cash than is sought by the seller. All of the factors mentioned above regarding price are applicable here.

Rarely do buyers have cash on hand to fund the entire purchase price. Rather, most buyers spend a great deal of their acquisition energy in working out the financing details. In some cases, the buyer has other assets or the acquired assets are unencumbered, making a bank loan or an asset-based loan from a finance company a good source of cash. The buyer's ability to quickly obtain this financing can be of real benefit in allowing him to close the deal and to possibly obtain a better price. It is desirable for the buyer to have discussed his plans in advance with his bank or other financing sources. Other sophisticated financing methods may be used in certain cases. The buyer may also look to the seller as a source of financing or negotiate a purchase price payable in a form other than cash. These considerations are discussed in more detail in Chapter 3.

3. Other Considerations

All buyers must spend a significant amount of time investigating the present status and future prospects of the target company, underestimating neither the time nor the financial commitment necessary to do this investigation. It is substantial and expensive and may lead to a buyer's walking away from a target. However, this may be the best money spent by a buyer if it prevents him from making the wrong acquisition, which will prove far more costly in dollars, time and emotional stress.

The areas that a buyer should consider are the target's products and markets, its management and labor situation, its sources of supply and distribution, its marketing and advertising, its reputation, its industry and its competition. A complete review of the seller's financial condition must be undertaken by the buyer and/or the buyer's accounting firm. The buyer's attorneys will also want to review the seller's corporate records, major contracts and any lawsuits to which the seller is a party. The transaction may also raise antitrust issues when a buyer is purchasing a competitor.

Additionally, the buyer will be concerned with the income tax aspects of certain transactions, e.g., whether he is attempting to use or to acquire a net operating loss or whether the buyer seeks to write up the tax basis of the assets to their fair market value. A buyer, especially a public company, should consider the accounting implications of an acquisition with its accountants at an early point in the negotiations.

Use of Brokers and Investment Bankers

Business brokers, finders and investment bankers can make a significant contribution by finding and negotiating "deals" for companies that want to buy, sell or merge their businesses. Not only can they locate the target (potential buyers), but they can perform other services, including helping to analyze the target's financial condition, product lines and markets, and they can help value, structure and negotiate the transaction and any related financing.

Finders, brokers and investment bankers are not all alike. Technically, a finder's sole function is to introduce a prospective buyer to a prospective seller. As such, a finder is purely a middleman and has no allegiance to either party. A broker, on the other hand, not only finds the other party but participates in the negotiations. In some cases, the broker may represent "the deal," but more often than not he acts as agent for one of the parties, and frequently each side is represented by a broker or investment banker as well as by its accountants and attorneys. A more skilled broker, such as an investment banker who may be involved in large transactions, may be a key factor in making a deal happen.

As a practical matter, the distinction among finders, brokers and investment bankers is not always clear. It is important for a seller or a buyer to know with whom it is dealing, what service will be performed and at what compensation. Any agreement with a finder, broker or investment banker should be in writing. This agreement may be the most important agreement that the buyer and seller enter into, other than the acquisition document itself, due to the size of the fee involved. One must be careful to avoid unintentional oral or casual retention of brokerage services in light of the magnitude of fees that can be claimed for having facilitated a transaction.

In general, there are no fixed rules as to the compensation to be paid to finders or brokers. Usually a fee is payable only if the deal closes.

In smaller transactions, the rate may be a flat rate from 5% to 10%. In very large deals, the fee may be as low as 0.5% to 1.0%.

A common fee structure is what is known as the "Lehman formula," or the "5-4-3-2-1 formula." Under this formula, 5% is paid on the first $1,000,000 of sales price, 4% on the next $1,000,000, 3% on the next $1,000,000, 2% on the next $1,000,000, and 1% on amounts in excess of $4,000,000. There are many variations on this theme. In recent years, "incentives" have been used, such that fee percentages increase if sales proceeds exceed certain targets.

Since finders, brokers and investment bankers generally work on contingent fees, which usually will average well under 10% of the sales price, and since most can play a valuable role in the transaction, their services are worthwhile if they help the buyer to find the right seller or the seller to find the right buyer.

Use of Accountants, Attorneys and Others

In any given transaction, there may be other professionals whose services are desired. Bankers are not only a source of funds; a number of large commercial banks have established merger-and-acquisition departments to assist in the matchmaking process. Banks may also have departments that assist in the valuation of closely held corporations. Additionally, there are other outside valuation consultants, e.g., real estate appraisers and used machinery dealers, whose services can be beneficial. In cases involving pension plans, an actuary or other pension consultant may have to be retained. A buyer may want to engage an information technology consultant if the buyer plans to integrate the seller's accounting records into his computer system. In some transactions, the buyer may want to hire an environmental consultant to evaluate any potential environmental issues. However, both buyers and sellers will rely most heavily on their accountants and attorneys.

As has been indicated, there are numerous services that both accountants and attorneys can provide. If advice is sought early, and if all parties, including accountants and attorneys, do their due diligence to bring any major problems into the light of day, the likelihood of dispute following the closing is greatly reduced.

The accountants' services may include an interim audit of the seller's financial condition or a lesser-scale review. The accountants should perform cash flow projections and pro forma financial statements for future periods to demonstrate that the buyer will be able to service any debt incurred and to show the impact of the transaction on the buyer's future earnings.

The attorneys' services will include a review of the confidentiality agreement, the letter of intent, the broker's agreement, and the other party's corporate records, contracts, litigation and legal condition. The attorneys will participate in the negotiations and draft the acquisition agreement and other related documents. There will be directors' and shareholders' meetings. With public companies, there may be proxy solicitations and other securities law considerations. The accountants and attorneys will analyze the tax consequences of the transaction. Union negotiations or new labor contracts may be required. An analysis of existing pension obligations and new benefit plans will be necessary.

Above all, tell your accountants and lawyers about any problems with your business. The very thing you would not like the other side to know may become the key fact in subsequent litigation. Full disclosure must be made to the other side, or there will be problems later. Your accountants and attorneys, who have been through the acquisition process before, will know how to help you deal with any problems you may encounter.

Chapter 2

Structure of the Transaction

Often, the tax treatment of the sale of a business will be the determining factor in structuring the form of the transaction. Tax considerations are discussed in Chapter 5. This chapter outlines some of the nontax issues that should be considered in structuring an acquisition of a business.

Purchase of Assets: The Buyer's Perspective

1. Avoidance of the Seller's Liabilities

A buyer will frequently favor a purchase of all, or substantially all, of the seller's assets, as opposed to an acquisition by purchase of stock, or by merger or consolidation with the target company. Through an asset acquisition, the buyer may hope to avoid liability for the obligations of the target company other than those specifically assumed by the buyer. In contrast, if the buyer acquires the stock of the target company, the target (or its successor by merger or consolidation) will remain liable for all of the obligations of the target, whether or not those liabilities were specifically assumed by the buyer.

> **Bulk Sales Acts**: Avoiding the seller's liabilities through an asset purchase requires careful planning. Where the bulk of a seller's inventory is sold outside the normal course of business by a company that is engaged primarily in the sale of merchandise from inventory, compliance with the bulk sales laws (if any) of states in which the inventory is located becomes a consideration. Unless both the buyer and the seller comply with the provisions of any applicable bulk sales statutes requiring advance notice to the seller's creditors, the buyer will remain liable for the claims of the seller's creditors. Moreover, the applicable states may have tax laws similar to the bulk sales statutes, which provide that a buyer in a bulk transfer will be liable for state sales or other taxes owed by the seller unless appropriate notification has been given to the state taxing authority. Often, the buyer will require the seller to satisfy his debts before the sale, or will hold back part of the purchase price in an escrow until all of the seller's obligations are paid.
>
> **Product Liability Claims**: Where all of a manufacturing company's stock has been sold, or if the company has merged or consolidated with another corporation, the manufacturer (or the surviving corporation) remains responsible for the claims of persons injured by goods manufactured by the seller before the sale. Additionally, the courts of many states have found the buyers of assets to be "successors" to the sellers for purposes of product liability claims,

even where product liability claims are expressly not assumed. This is particularly true when the business of the seller continues in the same location without interruption and the buyer manufactures the same line of goods as did the seller. The best protection in an asset sale against such "successor" product liability claims is insurance; the buyer should require the seller to continue insurance coverage for the benefit of both the buyer and the seller for an agreed period after the sale.

Contracts: The buyer will want to buy assets if the selling company has entered into burdensome agreements that the buyer does not wish to assume. For example, the seller may have put in place expensive pension plans or may be a party to a labor contract that the buyer wants to avoid. In the case of a labor contract, the buyer will nevertheless have a duty to bargain with the union unless the business and the work of the employees is substantially changed after the sale.

Environmental Cleanup Claims: In most situations, asset purchasers generally are not liable as successors for environmental cleanups. Some courts, however, have subjected asset purchasers to liability under the Comprehensive Environmental Response, Compensation and Liability Act of 1980 (CERCLA), as amended by the Superfund Amendments and Reauthorization Act of 1986. The courts have held an asset purchaser liable when the asset purchaser expressly or implicitly agreed to assume the liability, when the sale amounted to a "de facto" consolidation or merger, when the transaction was entered into to escape liability or when the buyer was merely a continuation of the selling corporation. Circumstances indicating a continuation of the selling corporation have arisen when the successor continued to use the same location, logo and employees as the predecessor. The best protection against unwanted "successor liability" is to allocate the cleanup responsibilities in the acquisition agreement and/or to require the seller to clean up the hazardous-waste site before the deal is closed.

2. Avoidance of Negotiations with Multiple Stockholders

If the target company has numerous stockholders, it may be only practical for the buyer to purchase assets rather than engage in negotiations with all of the stockholders. In addition, the buyer may prefer a purchase of assets in order to avoid the appraisal rights of dissenting stockholders. Prior to any sale of all of its assets, the stockholders of the target company must approve the transaction by at least a majority vote, and in many cases by a greater vote. Stockholders who dissent from the transaction may be entitled to an appraisal of and payment for their shares. Following a sale of assets, satisfying the dissenting stockholders will be the obligation of the seller, not the buyer. The buyer need only be concerned that the sale is approved by the requisite number of stockholders. For the same reason, the buyer may decide against a merger or consolidation with the selling company. Stockholders who dissent to a merger or consolidation are always entitled to appraisal rights. After a merger or consolidation, the settlement of those rights would be the responsibility of the surviving or new corporation, i.e., the corporation now controlled by the buyer.

Purchase of Assets: The Seller's Perspective

A seller may prefer an asset sale, rather than a sale of stock, a merger or a consolidation, if the seller has assets that he does not want to sell to the buyer, or if the selling company anticipates continuing business after the sale. There are, however, tax disadvantages to sellers of assets, which are discussed in Chapter 5. Of course, the assets and business that are not to be sold could be transferred to another corporation owned by the seller's stockholders prior to any sale to the buyer, but that sort of transaction is not always convenient or tax efficient.

Purchase of Stock: The Buyer's Perspective

1. Nonassignable Assets

A buyer will prefer a stock sale in situations in which it is impossible or inconvenient to obtain ownership of the seller's assets by assignment. For example, if the seller has favorable leases or supply arrangements that cannot be assigned, a purchase of stock may be necessary because contracts usually continue uninterrupted between the original parties regardless of any change in ownership of one of them. A merger or consolidation can accomplish the same objective because the surviving or new corporation is merely the continuation of the constituent corporations for purposes of contract obligations. If the seller has numerous contracts, each requiring the consent of the other party before the contract can be assigned, the time and effort involved in obtaining such consents, even if the other parties are amenable, may dictate a stock sale or a merger or consolidation.

2. Publicity

A stock sale of a closely held company can be accomplished with little or no publicity to the creditors and customers of the seller. An asset purchase, on the other hand, may require obtaining consents to the assignments of contracts and notification under any bulk sales laws of the applicable states. The buyer may feel that wide publication of the change of ownership inherent in an asset sale would not be in the best interests of the newly acquired company.

Purchase of Stock: The Seller's Perspective

1. Convenience

The seller (and, but for tax disadvantages, probably the buyer as well) will prefer the convenience of a stock sale to the more complicated sale of assets. For an asset sale, each asset must be assigned, so that bills of sale, deeds, trademark, patent and copyright assignments and similar documents must be prepared, executed and, where necessary, filed of record. Consents must be prepared and obtained from the other parties to contracts that are being assigned. The obligations that the buyer is to assume must be listed and described. A stock sale, on the other hand, requires only the assignment of the outstanding shares of the target company's stock. A merger or consolidation will require the filing of various corporate documents and requisite stockholder votes. In general, a stock sale, merger or consolidation can be accomplished more rapidly and with less difficulty than an asset sale.

2. Assumption of Liabilities

The seller will prefer a stock sale when it wants to dispose of the company "lock, stock and barrel." That is, the selling stockholders will prefer to transfer all of the obligations and liabilities of the selling company to the buyer rather than allow the buyer to pick and choose among those liabilities that he will assume. Of course, in a stock transaction, the selling stockholders are frequently asked to indemnify the buyer against certain liabilities.

Acquisition of a Business through a Leveraged ESOP

1. ESOPs Generally

An employee stock ownership plan (ESOP) is a tax-qualified retirement plan designed to invest primarily in employer stock. Through an ESOP, participants obtain an ownership interest in the employer corporation, but the ESOP (acting through its trustee) remains the actual shareholder of record. Throughout the years, ESOPs have been used to purchase existing businesses from individual shareholders and subsidiaries being sold by conglomerates. These acquisitions are made through "leveraged" ESOPs, where the ESOP borrows money with the assistance of the employer to purchase employer stock.

Since ESOPs are designed to promote the concept of employee ownership, there are several tax incentives to encourage ESOP transactions. Employers often find that it is difficult to promote broad-based employee ownership with other vehicles because employees may not have access to capital and there are federal and state securities law concerns. Often, these concerns are avoided with an ESOP. Moreover, ESOPs typically promote long-term employee ownership, which is something that employers do not always experience with other programs, such as stock option plans.

2. Leveraging Advantages

In a leveraged ESOP transaction, the employer or selling shareholder typically makes a loan to the ESOP with funds from a loan obtained from a commercial lender. If the loan is made from the commercial lender (or selling shareholder) directly to the ESOP, the lender will typically require a guarantee from the employer. The ESOP is permitted to use the loan only to purchase employer stock, and that stock is the only collateral an ESOP may pledge to a lender to secure the loan. The employer corporation agrees to make annual cash contributions to the ESOP sufficient to amortize the loan. Subject to the annual limits under the Internal Revenue Code, these contributions are fully tax deductible.

3. Structure of Leveraged ESOP Transaction

The basic leveraged ESOP financing transaction is as follows:

(a) The employer corporation establishes an ESOP plan and appoints a trustee for the ESOP trust. The trustee can be an institution (i.e., an independent trustee) or a group of corporate officers.

(b) The employer corporation, or one or more of its shareholders, contracts to sell to the ESOP an agreed-upon number of shares of the employer's stock at their fair market value (determined as of the date of the sale by an independent appraiser).

(c) The employer corporation borrows an amount equal to the purchase price for the shares from a bank or other lender, with customary arrangements made for collateral. The ESOP borrows the money from the employer corporation to purchase the shares from the seller.

(d) The ESOP pays the loan proceeds to the seller in payment for the shares it has contracted to purchase.

(e) If the employer corporation is the seller and is purchasing another business, it then uses the proceeds of the sale of stock to the ESOP to purchase the assets or stock of the other business.

(f) In future years, the employer corporation will make contributions to the ESOP sufficient to repay the principal and interest on the loan. The ESOP will first pay the employer corporation, and the employer corporation will then pay the lender.

The advantage to the corporation utilizing the ESOP is that its contributions, which are ultimately applied to the payment of both principal and interest on its loan, are tax deductible. In contrast, if the corporation used conventional financing, the corporation's payments on the loan would be tax deductible only to the extent attributable to interest. Moreover, if certain requirements are met, the ESOP can also use dividends paid on employer stock to make loan payments, and the employer can claim a tax deduction for these dividends.

4. Various Leveraged ESOP Uses

Theoretically, leveraged ESOP financing can be used whenever a corporation would use conventional debt financing. Thus, it can be used for financing corporate growth, tender offers, acquisitions, going private, purchasing stock from a shareholder or increasing the corporation's working capital. Leveraged ESOPs are thought to be especially useful in mergers or divestitures of subsidiaries and shareholder buyouts.

A leveraged ESOP may be used to acquire another company by following the four steps outlined below:

(a) The ESOP borrows funds equal to the purchase price of the stock or assets of the target company.

(b) The ESOP buys the stock of the employer corporation or a newly formed subsidiary of the employer corporation.

(c) The employer corporation or new subsidiary purchases the stock or assets of the target company.

(d) The employer corporation guarantees the ESOP loan and makes annual contributions to the ESOP until the loan is paid.

Assuming the corporation is in the 35% tax bracket, it may make the acquisition at approximately two-thirds the cash costs of conventional debt financing. However, the corporation must realize that its earnings and equity will be diluted.

Similarly, a leveraged ESOP may be used in the divestiture of a division of a corporation. One way to accomplish a divestiture is as follows:

(a) The divesting corporation creates a subsidiary corporation and transfers to it the assets and employees of the division.

(b) The new subsidiary borrows funds from a lender and re-lends the proceeds to the subsidiary's newly established ESOP.

(c) The ESOP purchases the stock of the new subsidiary from the parent corporation.

(d) The new (former subsidiary) corporation makes annual contributions to the ESOP to amortize the loan.

5. Seller's Incentive

Section 1042 of the Internal Revenue Code of 1986, as amended (the Code), provides a major incentive for a shareholder, other than a C corporation, who sells employer stock to an ESOP. Section 1042 permits an eligible shareholder to elect to defer paying capital gains taxes on the sale to the ESOP if, among other requirements, the sale proceeds are used within three months prior to, or 12 months after, the sale to purchase "qualified replacement property." This generally consists of stocks or bonds issued by another domestic operating corporation. Other major requirements under section 1042 include the following: (i) the seller must have "a holding period" of at least three years in the employer stock sold to an ESOP, (ii) immediately after the sale, the ESOP must own at least 30% of either each class of outstanding employer stock or the total value of all outstanding employer stock (determined on a fully diluted basis), (iii) the employer stock sold to the ESOP must be issued by a domestic C corporation that has no outstanding stock readily tradable on an established securities market, and (iv) the seller must not have acquired the employer stock from a qualified retirement plan, nonqualified plan or stock option plan.

Although there are many technical and procedural requirements that must be followed to make a section 1042 election, it could provide a significant tax benefit for a seller. Indeed, as long as the step-up basis rules are in effect, a section 1042 election could preclude the seller from ever paying federal income taxes in connection with the sale of employer stock to an ESOP if the qualified replacement property is not sold prior to the seller's death. Of course, if the seller disposes of the qualified replacement property during his lifetime, then capital gains taxes will be incurred at that time (based on the cost basis of the stock sold to the ESOP).

6. S Corporation ESOPs Are Not Taxed

Since 1998, ESOPs have been permitted to be S corporation shareholders. Although initially ESOPs were to be taxed on their share of corporate income that normally flows through to S corporation shareholders, Congress subsequently reexamined this matter so that ESOPs would not be subject to this tax. Accordingly, if an ESOP owns 100% of an S corporation, there is no federal income tax imposed on the operating earnings of the S corporation. Many corporations that have ESOPs as a majority shareholder have in recent years structured transactions to increase ESOP ownership to 100% to take advantage of this tax benefit.

To form an S corporation, an election must be filed with the IRS. Various requirements have to be satisfied to make such an election, including but not limited to a 100-shareholder limit. Since the ESOP is considered to be the shareholder, this rule is not impacted by the number of ESOP participants.

There are rules in place to ensure that this tax benefit is available only to ESOPs that have broad employee participation. Excise taxes are imposed under the Code if an S corporation sponsors an ESOP but, in reality, most of the corporation is owned by a few individuals. In general, these taxes may apply if (a) there are five or fewer individuals who own, individually, at least 10% of the corporation (based on stock in the ESOP and synthetic equity) and, in combination, at least 50% of the corporation (including stock held outside of the ESOP), and (b) any of those individuals have stock allocated them in the ESOP or have an interest in an equity compensation, or a nonqualified deferred compensation, arrangement with the employer outside of the ESOP.

7. Allocations, Distributions and Limited Voting Rights

The stock acquired by the ESOP is initially held in an unallocated suspense account. Shares are released from the suspense account each year, as loan payments are made, and the released shares are allocated to the accounts of the eligible participants (usually in proportion to recognized compensation under the ESOP). Shares that are allocated may no longer be part of the collateral for the loan. While the ESOP is the shareholder of all of the employer stock in the ESOP, participants may have limited pass-through voting rights on the shares allocated to their accounts. In general, for ESOPs sponsored by nonpublic corporations, pass-through voting applies only to extraordinary events (e.g., mergers, recapitalizations, reorganizations, sales of substantially all of the assets or liquidations), and not on more routine matters, such as voting in board elections. For ESOPs sponsored by publicly traded corporations, there must be pass-through voting on the allocated shares for all shareholder voting matters. The pass-through voting rules do not have to be extended to the unallocated shares in the suspense account. When voting rights are not passed through to participants, the decision on how to vote these shares would be made by the ESOP trustee or another fiduciary designated in the ESOP documents.

When a participant is entitled to a distribution after termination of employment, the timing and method of the distribution depend on a number of factors. In general, in connection with death, retirement or disability, distributions have to be made available by the end of the following plan year. For regular termination of employment, distributions do not have to be made available until the end of the following sixth full plan year or, if later, after the corresponding loan has been paid in full by the ESOP. Distributions can be made in lump sums or in periodic payments over five years (increased to up to 10 years for participants with relatively large account balances).

For nonpublic corporations, there are exceptions to the general rule that distributions must be offered in the form of employer stock. If the corporation's governing documents limit ownership to employees and the ESOP, or if the ESOP is sponsored by an S corporation, distributions of allocated stock can be made either in cash (based on the most recently appraised value) or in stock with a requirement that the participant immediately sell the stock back to the employer in a manner that complies with the put-option rules.

The put-option rules apply to stock issued by a nonpublic corporation that has been distributed by the ESOP. In general, the person who received the distribution has two opportunities to exercise the put option and require the employer to purchase the stock at its most recently appraised value. If the ESOP distribution was made in a lump sum, the employer can elect to make payments over a five-year period if it provides interest and adequate security on the unpaid balance. A nonpublic corporation can also impose a right of first refusal on the stock distributed from the ESOP. This prevents the stock from being sold to a third party unless it is first offered to the employer.

Chapter 3

Type of Payment

A crucial part of every transaction, for both the buyer and the seller, is agreeing on the amount and the form of the purchase price. In most transactions, the purchase price will be paid in cash, notes or other debt obligations, stock or some combination thereof. In addition, some transactions may include earnouts based upon the future earnings performance of the entity being sold. While the types of consideration set forth have all been used and will continue to be used in transactions to fit the requirements of buyers and sellers, most negotiations commence with discussions based on a cash purchase price and proceed to the other possibilities when the parties are unable to agree on a satisfactory cash price.

Cash

Cash is the initial starting point in most discussions concerning the purchase or sale of a business, since all parties to the transaction have a clear idea of the value of cash. In addition, cash transactions have the benefit of being relatively straightforward. On the closing date, the buyer transfers $X to the seller in return for the business being purchased. At this point, both parties know exactly what has been given up and what has been received, and they can both then go their separate ways. Such a transaction avoids post-closing entanglements between the buyer and the seller that often arise when other types of consideration are used.

The benefits of a cash transaction are often of major importance to a seller. Once the seller has made the decision to sell the business, he may want to receive his payment at closing and be able to walk away without further concerns about the business he has given up.

The buyer, on the other hand, generally has the opposite view. A cash transaction leaves him with very little recourse (except a lawsuit) if the seller is not inclined to be reasonable about a breach of the agreement. Because of this fact, a buyer frequently seeks escrows or holdbacks in cash transactions.

Notes or Debt

In those cases in which the buyer cannot or will not come up with the entire purchase price at closing, an alternative is that the seller take back a note or other debt obligation from the buyer at closing, which provides for periodic payments to the seller.

From the buyer's vantage point, notes provide a method whereby the buyer reduces the amount of cash needed to purchase the business. This often allows the buyer to pay for the new business out of the cash flow generated by the target company. In addition, notes are often used by a buyer to obtain a de facto escrow or a holdback. As long as the notes are outstanding, the buyer may be able to withhold payments due by asserting a claim against the seller for a breach of the agreement.

From the seller's point of view, notes raise several issues that are not present in a cash transaction. An important consideration for the seller is the amount of interest to be paid on the principal of the note. An additional complication for the seller in such transactions is that, at closing, the seller has become a creditor of the buyer. Until the seller has received full payment, he must rely on the buyer's ability to pay the note when due. As a creditor, the seller will have to look at the buyer's financial wherewithal and decide whether to require appropriate security for the notes.

At a minimum, many sellers require that they receive a security interest in the assets or stock being transferred to the buyer until the notes are fully paid. Such a requirement can cause problems in transactions involving outside financing. The financing agency may also want a first security interest in those same assets and may also seek to restrict the seller's ability to be repaid and to exercise his remedies in respect of the acquisition indebtedness in certain circumstances. A second and related point is what restrictions, if any, the seller feels he must impose on the buyer's business operations until the notes are repaid. To the extent that the seller obtains a security interest, he may also want to restrict the buyer's freedom of operation and ability to deal with those assets by imposing restrictions on financial ratios, cash outlays, extraordinary business transactions, dividends and salaries as well as other negative and affirmative obligations.

A seller's attempt to impose these restrictions will often cause problems for a buyer, who will take the position that he needs an unfettered right to operate and deal with the new business in the manner in which he sees fit. The range of possibilities in this situation is obviously very broad and will depend on the relative strengths and merits of the arguments that the buyer and seller can raise as to what security and restrictions, if any, should be required of the buyer.

One final point in this discussion, which is often ignored until the buyer's attorney presents the draft purchase agreement to the seller, is whether or not the note will be negotiable. As previously discussed, the buyer often uses a note as an escrow or a holdback of part of the purchase price against which he can make claims for any breaches of the purchase agreement. From this perspective, it is obviously in the buyer's best interest to have any such note be non-negotiable.

The seller's position is diametrically opposed to the buyer's because the seller wants to be able to sell the note whenever he so desires. Selling such a note would obviously be difficult if a note is non-negotiable and subject to any claims the buyer might want to make under the agreement.

Equity Securities

Equity securities, the popularity of which goes up and down with the stock market, are a third type of consideration. When a seller accepts the buyer's own equity securities in consideration for his company, he is, in effect, trading one investment for another. The seller must decide whether he wants to make an investment in the buyer. One question that both the buyer and the seller must agree on, and live with, is how and when to value the securities.

In those situations in which the securities to be transferred are quoted on a public market of some type, the question of value may be a relatively simple one—assuming the market is representative of the value in the proposed transaction. In those situations in which the securities are not quoted on a public market, both the buyer and the seller may have to retain experts to give them an opinion as to the actual value of the securities.

Where securities are quoted on a public market, the more important question becomes the timing of the valuation. If the securities are valued on a day other than closing, to the extent that the market price of the securities changes between the date the price is set and closing, there exists the possibility that the respective interests of the parties may change. If the price of the securities drops significantly before closing, the seller may think he is being underpaid for the transaction and that the buyer is getting a bargain. If the price of the securities increases significantly before closing, the buyer may think that he is paying a premium for the company.

For these reasons, it is often important that all parties to the transaction carefully consider what they are trying to get out of the transaction and negotiate a valuation date that provides them with assurances that their interests will be protected. Because of these problems, the parties to a transaction will often negotiate an evaluation based on an average price over a number of days and set a high and low limit as to the number of buyer shares that may be transferred at closing.

From the seller's point of view, it is important to remember that, when securities are taken in a transaction, they will often be restricted securities that, under current rules under the Securities Act of 1933 (the 1933 Act), generally cannot be freely resold for a period of six months or one year (depending on whether the issuer files reports with the SEC) from their date of acquisition. If the seller acquires enough shares of the buyer to become an "affiliate" of the buyer, the seller will also be subject to certain volume restrictions that may continue to limit the seller's ability to sell the shares. The seller should therefore carefully review the regulatory requirements that affect his handling and disposal of the securities so that he understands the full implications of accepting them. Specifically, the seller may want to negotiate certain registration rights.

Contingent Payments

A type of consideration that is often used when the buyer and the seller disagree about a company's future profitability is the contingent payment or "earnout." The basic form of the transaction is that the buyer will pay a portion of the purchase price to the seller at closing, and the remaining portion of the purchase price will be paid to the seller based upon the purchased business achieving certain goals with respect to earnings or some other financial criteria. While the basic concept is simple, earnouts raise a number of questions that must be addressed by both parties so that a mutually agreeable result is reached.

The initial issue is to determine the earnout criteria. For example, an earnout may be based upon revenues, gross profits, earnings before interest, taxes, depreciation and amortization, or any other measure of financial performance upon which the parties agree. Once this is decided, other questions can be addressed. The list of problems to be resolved can be endless: who will measure the earnout criteria; who will direct the business operations; who will have control over the major decisions that may significantly affect the performance of the company; will any changes in the business be allowed. The seller feels that the business must be tightly controlled to make certain that the earnout is achieved. The buyer takes the position that he has paid for the business and that he should be able to make decisions in his best interest without any restrictions. The basic problem in earnouts is that two parties, both acting in good faith, could make business and accounting decisions that would result in significant differences in the ability of the purchased business to achieve the agreed-upon goals. It is important for the parties to an earnout to discuss fully the parameters of the operation of the business and to put this in the contract.

Because of these uncertainties and the inherent problems that can arise even between parties making a sincere effort to resolve differences during an earnout, earnouts can present a real challenge and may be disappointing, particularly to a seller. However, where the parties are far apart in their estimation of value of a business, earnouts present a bridge to an agreement.

Holdbacks and Escrows

A final topic to be addressed is whether there will be a holdback or an escrow by the buyer of part of the purchase price. The buyer may often take a position that once he has paid the entire purchase price to the seller he is at a distinct disadvantage, as the seller has all the money and can take a hard-line position concerning any alleged breaches of the contract. This forces the buyer to file a lawsuit to recover any of the purchase price that has already been paid. To make up for this lack of leverage, the buyer will often propose that he "hold back" a portion of the purchase price to cover any such claims. The holdback will then be paid to the seller after any such claims are resolved. Having the buyer hold back part of the purchase price can often put the seller in the position of having to file suit against the buyer, who has attempted to lower the purchase price by making improper and untenable allegations of breach of contract.

The compromise often achieved in this situation is the use of a third-party escrow agent. This solution puts the parties on more even footing, since neither one will hold the money and force the other to sue. The third-party escrow agent will hold the money under a directive to pay the money due the seller at a certain date if no claims have been filed by the buyer. To the extent that claims are filed by the buyer for alleged breaches of the contract, the escrow agent will simply hold the money until it receives a joint written direction from the buyer and the seller or a court order directing it to dispose of the disputed money in a certain manner. To ease the minds of both parties, the escrow agent should be an independent bank or other institution.

The questions that arise concerning escrows are how much of the purchase price should be held and for what duration. These questions are not easily answered and have to be negotiated separately in each transaction based on the magnitude of any perceived claims that may be outstanding and the length of time it will take for these claims to become evident to the buyer.

Chapter 4

Letters of Intent and Other Presigning Considerations

This chapter discusses certain presigning considerations including letters of intent, public announcements and protection of information disclosed to a buyer.

Letters of Intent

A "letter of intent" in the context of business combinations is generally a preliminary statement that is sometimes adopted by the parties to an acquisition or merger at the time that the principal terms of the transaction have been determined. Such letters are usually prepared by counsel for the acquiring or surviving company and normally reflect the major terms of the proposed transaction, as well as any unique features or conditions upon which its consummation depends. The purpose of a letter of intent is to memorialize the basic terms governing the transaction prior to the preparation of the formal agreement and, in some instances, to serve as a basis for further negotiations. The use of a letter of intent should be carefully evaluated in advance to determine whether or not its utility would be offset by the hazards to which its use might give rise. In many, if not most, cases, a simple memorandum of terms, jointly prepared and agreed to by the parties but signed by no one, may be just as efficient and less dangerous.

The format of a letter of intent will vary with the circumstances of the transaction. Generally, however, the letter of intent should outline, briefly and clearly, the terms of the proposed transaction, stating the consideration involved and, if applicable, the nature of any deferred-payment, contingent-payment or earnout provisions. Additionally, any other important aspects of the transaction (such as escrow arrangements for a portion of the purchase price or employment, consulting or noncompetition agreements involved) should be set out. Also, any unusual conditions to closing or unique features of the transaction should be clearly summarized. Typically, these might involve provisions that certain interim action, prerequisite to consummating the transaction, would have to be effective prior to closing.

A letter of intent should clearly reflect the fact that neither party considers it to be a legally binding document, and it should further state that no rights are created in favor of either party by the document. Notwithstanding the fact that a properly prepared letter of intent is not, and is not intended to be, an enforceable agreement, such a letter should not be executed unless the parties have reached an agreement as to the basic terms of the transaction. If negotiations are still ongoing but, for one reason or another, a letter of intent is executed, a party desiring to negotiate different terms may be placed at a distinct psychological bargaining disadvantage. The party may be accused of negotiating in bad faith or of renouncing his agreement as memorialized by the letter of intent.

There are additional problems inherent in the use of a letter of intent, over and above the possibility of a weakened bargaining position. Specifically, a possibility exists that premature or undesired binding legal obligations may inadvertently be created through the use of a letter of intent. The buyer and the seller may both believe that the basic negotiations for the transaction have been concluded, so they sign a letter of intent. If the seller unilaterally decides not to proceed with the transaction, the buyer might bring an action based on the buyer's reliance on the seller's representations and willingness to proceed. The action may be brought for damages measured by expenses incurred that were contemplated by the letter of intent relating to the consummation of the transaction.

While use of a letter of intent may not be advisable in connection with many transactions, such letters do have some positive advantages in certain circumstances. For example, a letter of intent may be a useful listing of the principal terms from which the formal contract is to be negotiated. The letter of intent may also serve to clarify complicated terms in order to prevent misunderstandings. Finally, a letter of intent may be useful as a vehicle by which a relatively large number of persons who are involved in the transaction may be advised of its basic terms. Another use of a letter of intent can arise when one of the parties to the transaction needs to convince a third party, perhaps a bank or other lending institution, that a viable transaction exists and that the other party has agreed to proceed on a reasonably definitive basis. These considerations may override the disadvantages of the letter of intent's use.

Public Announcements and Press Releases

Questions concerning the timing and nature of publicity issued in connection with business combinations of public companies have become increasingly important in recent years. Failure to disclose an important transaction, or issuing a misleading disclosure, has the potential for substantial economic injury to a company and its stockholders and can give rise to claims against officers and directors who allegedly participated in the failure to disclose or the issuance of the misleading disclosure. Likewise, such a situation may also result in substantial gains by "insiders," who misappropriate material information for their own ends if the information withheld or inaccurately disclosed concerns a corporation whose securities are publicly traded. In a closely held corporation, a public announcement is not required; however, the officers and directors with inside information have a fiduciary duty to the stockholders to make full disclosure of all material information regarding any dealings involving the purchase or sale of any of the corporation's securities.

Regulation in the area of public disclosure of important transactions is pervasive. Accordingly, when discussions concerning a possible business combination enter into the serious stage, the nature and timing of the publicity to be issued in connection with the transaction should be considered very carefully from the standpoint of federal securities laws, state laws and, if applicable, stock exchange regulations. The nature and, in most cases, even the existence of such discussions must, of course, be kept confidential until public disclosure is made. While such regulation of publicity necessarily has a greater effect on public companies than on privately held entities, a privately held corporation is also subject to state and federal securities laws regarding disclosure requirements. When public disclosure of corporate activity is clearly called for, the existence, timing and nature of publicity releases can be a major factor in determining the liability of corporate officers and directors if litigation should occur.

The best course for companies to take when they begin preliminary discussions with a view to merger or acquisition is to establish a joint policy concerning the content and timing of press releases and all public relations activities associated with the negotiations. The most desirable system would include an arrangement whereby all press releases would be jointly composed and released. Such a policy would, to the extent possible, eliminate confusion as to the responsibility for publicity and, in addition, should provide a stable basis for the consistent flow of accurate information.

Chapter 5

Tax Considerations

Structuring the acquisition or disposition of a business involves many considerations. However, tax considerations generally drive the transaction. Proper tax planning is critical to achieving the desired end; without consideration of the tax consequences of each available alternative, the optimum structure cannot be selected.

The purchase and sale of a business may be structured as either a taxable or a nontaxable transaction. Within each category there are a number of alternatives available, and the one selected may require adherence to specific requirements of the tax laws in order to qualify for the anticipated tax benefits. The tax laws in this area are complex and are often amended; experienced legal counsel is indispensable to successfully structure the purchase and sale of any business.

This chapter describes in general terms the income tax consequences that flow from the primary alternatives that may be available. Specific qualification requirements are not discussed in detail, although they are described to enable the buyer and the seller to determine whether a particular structure is feasible. Some of the related federal income tax considerations of each alternative are also described to apprise the buyer and the seller of the tax consequences that flow from the transaction.

Taxable Transactions

Taxable transactions can be classified into two categories: sales of stock and sales of assets. In some circumstances, the sale of assets may be accomplished by contributing the assets to a newly formed, wholly owned limited liability company and selling the LLC interests because, for federal income tax purposes, this transaction is treated as a sale of assets so long as the LLC has not elected to be treated as a corporation for federal income tax purposes. The following discussion is limited to consideration of the sale of corporate stock and the sale of a corporation's assets. Some of the principles applicable to these types of transactions are also applicable to the taxable sale of limited liability company or partnership interests or assets, although other rules and regulations of the tax laws come into play when these entities are involved, and these rules and regulations must be considered in structuring the transaction. For a sole proprietorship, however, the only method available for the sale of the business is to sell the proprietorship's assets. Even if the sale is denominated as a sale of the proprietorship as a going concern, for tax purposes it would be treated as if all of the assets were sold.

1. Sale of Stock

A sale of corporate stock is a straightforward transaction by which the seller sells and the buyer buys stock in the corporation. The sale will generally result in the recognition of gain by the seller equal to the difference between the consideration received for his shares and his adjusted tax basis for those shares. The buyer acquires an asset (corporate stock) with a tax basis equal to the purchase price paid. The method used to pay the purchase price, however, will have an impact upon the tax consequences of both the buyer and the seller. In addition, there are options available to the buyer that will significantly impact the post-acquisition tax consequences.

Seller's Income Tax Consequences: Since the seller is simply disposing of an asset (corporate stock), his income tax treatment will depend primarily upon the way in which the purchase price is paid. The amount of the gain realized is equal to the difference between the consideration received for the stock and the seller's adjusted tax basis for that stock. The consideration received generally is the total of the money and the fair market value of any property paid to the seller. If the stock sold is a capital asset in the hands of the seller, and if the stock has been held in excess of one year, any gain recognized will qualify as a long-term capital gain. For noncorporate taxpayers, long-term capital gains are generally taxable at a maximum rate of either 15% or 20%, depending on the seller's top marginal federal income tax bracket on ordinary income. The 15% maximum long-term capital gains rate generally applies with respect to individual sellers whose top federal income rate on ordinary income is below the maximum 39.6% rate, while the 20% long-term capital gains rate applies to individual sellers who are subject to the top federal income tax rate of 39.6%. In addition, starting in 2013, sellers could be subject to an additional 3.8% tax on net investment income, including such capital gains. This tax is imposed on certain high-income individuals, estates and trusts with "net investment income" and will have the effect of increasing the top marginal tax rates imposed on such income. The applicable federal combined tax rate on such income will increase from 15% to 18.8% (for taxpayers who are subject to the 15% federal long-term capital gains rate) and from 20% to 23.8% (for taxpayers who are subject to the 20% federal long-term capital gains rate). Rules relating to this additional 3.8% tax on net investment income are discussed below.

The amount that must be recognized depends upon how the purchase price is paid. If the purchase price is paid in full at closing, then the entire gain will be reported in the year in which the closing takes place. This is true whether the seller is a cash-basis or an accrual-basis taxpayer. On the other hand, if the purchase price will be paid over time, or if there are any contingent payments, the gain will generally be reported only as the payments are actually received.

In certain cases, sellers may reduce their effective capital gains rate. For sellers other than corporations, Code section 1202 excludes from gross income 50% of the gain recognized on the sale or exchange of qualified small business (QSB) stock held for more than five years. This exclusion percentage may be increased for QSB stock acquired by the seller after February 17, 2009 and prior to January 1, 2014. For QSB stock acquired after February 17, 2009 and on or before September 27, 2010, the applicable exclusion percentage is 75%. For QSB stock acquired after September 27, 2010 and prior to January 1, 2014, the applicable exclusion percentage is 100%. The 100% exclusion also applies for purposes of the alternative minimum tax (AMT). In addition, a special rule increases the exclusion percentage to 60% (assuming the QSB stock is not eligible for the 75% or 100% exclusion discussed above) for QSB stock of certain corporations that meet the definition of a "qualified business entity" within the meaning of Code section 1397C(b). Gain eligible for this exclusion under Code section 1202 is limited to the greater of $10 million or ten times the seller's basis in the stock. In general, corporate stock is treated as QSB stock if it satisfies certain specific conditions, including, but not limited to, the following: (i) the stock must have been originally issued after August 10, 1993; (ii) the corporation issuing the stock must be a C corporation; (iii) the stock generally must have been acquired at its original issue in exchange for cash or other property (except other stock) or as compensation; and

(iv) the corporation issuing the stock must satisfy "active business" and other requirements imposed by the Code.

Note, however, that the gain on the sale of QSB stock that is not excluded from gross income under Code section 1202 is not eligible for the reduced capital gains rates that were originally enacted in 2003, and such gain will instead be subject to the prior law's maximum rate of 28%. Thus, if the QSB stock is a long-term capital asset, the effective tax rate for gain on QSB stock is 14% for sales occurring in years after 2013, based on the 28% capital gains rate and the 50% exclusion of section 1202. Sellers should consult their tax advisors to ensure that the necessary planning is accomplished prior to any sale.

A noncorporate seller may also make an election under Code section 1045 to avoid tax on the capital gain from a sale of QSB stock held for more than six months by rolling over the sales proceeds into other QSB stock.

(a) **Deferred Payments**: If payment of a portion of the purchase price is deferred, then the gain may be reportable under the installment method. As a threshold question, the seller must determine whether and to what extent the installment sale method is available. For example, if the stock sold is traded on an established securities market, the installment method is not available. Thus, the entire gain is reportable in the year of sale, even if all or a portion of the sale price will be paid in the future. Sellers should consult tax counsel to determine the availability of the installment method or alternative structures to lessen the federal income tax upon a deferred-payment sale. Even if the sale qualifies for the installment method, the seller may elect to report the entire gain in the year of the sale. If the election is not made and the installment method is available, the amount that is reportable as income each year depends upon the portion of the deferred sales price received each year. Interest income on the deferred payments must also be reported. After the total gain is determined by comparing the total sales price to the seller's tax basis in the stock sold, a gross profits percentage is determined by dividing that gain by the total payments that will be received, excluding interest but including any down payment. This gross profits percentage is applied to the down payment, if any, and each payment of the deferred sales price that is received; that portion of each payment is treated as gain from the sale of the stock in the year in which the payment is received and will be subject to the then-applicable tax rates.

There are additional tax consequences relating to the use of the installment method. Interest must be paid on the taxes that are deferred by using the installment method if the sales price exceeds $150,000 and the face amount of all installment obligations held by the seller that arose during, and are outstanding at the end of, the taxable year exceed $5 million. The interest is payable only with respect to the taxes that relate to the portion of the sales price that exceeds the $5,000,000 threshold.

In addition, if the installment obligation is pledged to secure any other indebtedness, the net proceeds of that secured indebtedness will be treated as an actual payment received under the installment obligation. This will accelerate the tax liability of the seller. An arrangement that gives a seller the right to satisfy an obligation with the installment note will be treated in the same manner as the direct pledge of the installment note. As with the interest rule described above, this pledging rule will apply only when the sales price exceeds $150,000.

(b) **Interest**: Deferred-payment contracts will generally provide for interest on the amount of the sales price that is deferred. This interest must be reported as ordinary income by the seller in the year in which the interest is received (for a cash-basis seller) or is due (for an accrual-basis seller). Setting the interest rate is a matter for negotiation between the buyer and the seller. However, the tax law does have an impact in this area.

The tax law contains original issue discount and imputed interest rules, which ensure that a proper rate of interest is charged, ensure that interest is included in income as it is economically earned, and prevent the conversion of what would be ordinary income into a capital gain by understating the amount of interest and overstating the deferred-payment price. For example, if stock worth $1,000,000 is sold and the payment is deferred for three years, the buyer and the seller could determine that the deferred payment should bear interest at 7% per year, compounded annually. Total interest is approximately $225,000 for the three years. The buyer and the seller could, in lieu of charging interest, simply increase the purchase price to $1,225,000. Barring the statutory provisions on original issue discount and imputed interest, this would result in the reporting of a larger capital gain by the seller in the third year and no interest income in any intervening year.

The original issue discount and imputed interest rules are designed to ensure that each contract for a deferred-payment sale will properly reflect interest. Where interest is imputed, the deferred sales price and interest, if any, as specified in the contract, will be adjusted accordingly. The adjusted deferred sales price will then be used to calculate the total gain and gross profit percentage and an adjusted interest amount, with such interest amount required to be reported as ordinary income.

Where the sales price of the stock exceeds $250,000, imputed interest will be determined under the original issue discount rules. Where the sales price is equal to or less than $250,000, interest will be calculated under the imputed interest rules. The primary difference between the original issue discount rules and the imputed interest rules concerns when the interest must be reported. Under the original issue discount rules, interest is reported each year, whether or not a payment of the deferred price is received; under the imputed interest rules, interest is reported only in those years in which payments of the deferred sales price are received (in the case of a cash-basis seller) or are due (in the case of an accrual-basis seller).

Under the original issue discount rules, interest is determined by comparing the redemption price of the deferred sales contract to its issue price. The redemption price is the total of all payments due under the deferred sales contract, other than interest payments that are not contingent and are payable at least annually. The issue price is determined by discounting back all these payments using a statutory interest rate, often referred to as the "applicable federal rate." The applicable federal rate is the federal short-term, mid-term or long-term rate, depending upon the term of the contract, each of which is published monthly by the IRS. The excess of the redemption price over the issue price, which is known as original issue discount, must then be reported as interest income over the term of the obligation.

Referring to the above example, and assuming that the applicable federal rate is 7%, the original issue discount is the difference between $1,225,000, which is approximately the total of all payments due under the deferred sales contract, and the present value of that amount at 7%, compounded semiannually. The present value is approximately

$997,000, and the difference of approximately $228,000 ($1,225,000 deferred sales price, less $997,000 present value) must be reported as interest over the three-year term of the obligation. The $997,000 becomes the sale price for purposes of calculating the gain and the gross profit percentage. Accordingly, the approximate interest that would be reported each year equals:

Year 1 $71,000

Year 2 $76,000

Year 3 $81,000

Thus, under the original issue discount rules, not only will more interest be reported than under the imputed interest rules, but a portion of that interest must be reported each year, even though no payments are received on the outstanding obligation.

Buyer's Income Tax Consequences: The primary disadvantage to the buyer of buying stock, as opposed to buying assets, is that the tax basis of the corporation's assets, which may be less than the fair market value used to arrive at the purchase price, does not change. If some of the assets have appreciated in value or have a fair market value higher than their adjusted tax basis, the buyer obtains no immediate tax advantage (e.g., depreciation or amortization deductions) for paying a higher price for the stock.

(a) **Section 338 Election**: Code section 338 allows a corporate buyer that acquires stock to elect to treat the transaction as if the corporation's assets had been acquired. If elected, there will be a step-up in the tax basis of the corporation's assets to reflect the price paid for the stock. If the section 338 election is made, the target corporation (the corporation whose stock is purchased) is treated as (i) having sold all of its assets on the stock purchase date and (ii) having purchased those assets, acting as a new corporation, on the next day.

Generally, the target corporation that is subject to a section 338 election will recognize gain equal to the difference between the purchase price for its stock and its tax bases for all of its assets. Thus, unless the target corporation has a net operating loss carryover (or other tax attributes) that can offset this income, or the consolidated group, if any, in which the target was a member has such a carryover or attribute, or other special circumstances exist, the section 338 election is not advisable.

For example, assume that a target corporation's stock is purchased, that $1,000,000 of the purchase price is allocable to machinery and equipment and that the adjusted tax basis for the machinery and equipment is $300,000. If a section 338 election is made, the target will have a taxable gain of $700,000. At the top corporate tax rate of 35%, this results in a tax liability of $245,000. Although the tax basis for the machinery and equipment will be increased by this $700,000, the $245,000 of tax savings from depreciating this additional basis (35% times $700,000) will be realized over a seven-year period of time. Clearly, the present value of the tax savings for the increased depreciation deduction is less than the tax cost of the immediate gain recognition. If, however, sufficient net operating losses exist to offset the $700,000 gain of the target corporation, a section 338 election may be advisable.

(b) **Section 338(h)(10) Election**: The more frequently used Code section 338(h)(10) election allows a deemed asset sale result when a buyer acquires the stock of a subsidiary from a consolidated or affiliated group of corporations or acquires an S corporation. For example, assume a parent corporation in a consolidated group desires to sell a subsidiary with the same factual characteristics described above. If a Code section 338(h)(10) election is made, the parent corporation will not recognize gain on the sale of stock. Instead, only the target corporation, while it is a member of the selling consolidated group, will recognize gain (resulting in a $245,000 federal income tax) on the deemed asset sale and will then be considered to have liquidated. Due to the rules applying to liquidations of corporate subsidiaries, the section 338(h)(10) election does not result in double taxation. Similarly, when the target corporation is an S corporation, the S corporation rules will generally result in only a single level of federal income taxation. In order for Code section 338(h)(10) to apply, the buyer must be a corporation, and both the buyer and the seller must jointly make the election. Accordingly, this election allows the buyer to benefit from the future tax advantages (e.g., depreciation and amortization deductions) without subjecting the seller to a double tax (i.e., tax on the stock sale, in addition to tax on the deemed asset sale of its subsidiary). However, state tax differences resulting from the section 338(h)(10) election and, especially when the target corporation is an S corporation, the different character of the gain resulting from the deemed asset sale must be closely examined by the seller and its tax counsel and may result in adverse consequences to the seller.

(c) **Section 336(e) Election**: In May 2013, the Treasury Department issued final regulations under Code section 336(e), which allow an election to treat a stock acquisition as an asset acquisition in a manner similar to the section 338(h)(10) election. Section 336(e), however, may be available in cases in which the section 338(h)(10) election is not available (e.g., where the buyer is not a corporation or where there are multiple buyers). The benefit of the election and the possible disadvantages of making the election are the same as discussed above in connection with the section 338 and section 338(h)(10) elections.

(d) **Interest Deduction**: Interest expense incurred by the buyer, including imputed interest and original issue discount, is generally deductible by the buyer, but it may be subject to limitation based on the amount of such expense and the source of the loan proceeds.

2. Sale of Assets

The sale of assets is advantageous from the buyer's standpoint in that the buyer is not acquiring a business entity that may be subject to contingent or unknown liabilities. In a stock sale, even if an indemnity is obtained from the seller to protect against future claims against the business, that indemnity is only as good as the assets that the seller has with which to back it up. Although some protection can be obtained through a holdback of a portion of the purchase price, this can be a cumbersome procedure that may lead to litigation.

From a tax standpoint, the purchase of assets is also advantageous to the buyer, since the buyer automatically obtains a step-up in the basis of the assets when the price paid is in excess of the seller's tax basis for those assets. However, the seller will be subject to tax on the entire gain it realizes on the sale of its assets. If the seller then liquidates, distributing the purchase price (net of corporate-level taxes) to its shareholders, the shareholders will be subject to a second tax if the target corporation is a C corporation. Because of this double tax, most sellers will not be willing to structure the transaction as a sale of assets unless they have net operating loss carryovers (or other tax attributes) to offset the corporate-level income or they receive a price adjustment to offset, at least partially, the additional tax burden. Sellers that are S corporations, however, have more flexibility and may avoid double taxation on an asset sale, although an asset sale may result in more ordinary income to the seller (taxed at higher rates than long-term capital gain) than a sale of stock and may have less favorable state tax consequences.

(a) **Buyer's Basis for Assets and the Amortization of Intangibles**: The general (and oversimplified) rule is that the tax basis of the assets purchased will be equal to their proportionate share of the overall purchase price based upon their relative fair market values, unless the agreement between the buyer and the seller specifically allocates the purchase price among the assets. Even where the purchase price is allocated by the buyer and the seller, section 1060 of the Code requires that the price be allocated among the purchased assets according to regulations issued by the Secretary of the Treasury (discussed further below).

Under Code section 197, buyers can generally amortize the capitalized costs (i.e., allocated purchase price) of acquired "section 197 intangibles" that are held by the buyer in connection with the conduct of a trade or business or an activity engaged in for the production of income. No other deduction for depreciation or amortization is allowed for an acquired section 197 intangible. The amount of the deduction is determined by amortizing the adjusted basis (usually the allocated purchase price) of the acquired intangible ratably over a 15-year period, beginning in the month in which the intangible was acquired, irrespective of the asset's actual useful life. The term "section 197 intangible" is defined as including the following types of intangible assets: (i) goodwill and going-concern value; (ii) workforce in place; (iii) information base and know-how (including patents and copyrights); (iv) customer-based intangibles; (v) supplier-based intangibles; (vi) licenses and permits granted by governmental units; (vii) covenants not to compete, but only if entered into in connection with the acquisition of a business or a substantial portion thereof; and (viii) franchises, trademarks and trade names.

Section 197 applies only to direct acquisitions of section 197 intangibles (i.e., asset acquisitions) and not to the indirect acquisition of the intangibles through an acquisition of stock. However, if the buyer makes an election under section 338 to treat the acquisition of stock as an asset acquisition, or if the buyer and seller join in an election under section 338(h)(10), section 197 will apply to the acquired intangibles (see discussion of section 338 and section 338(h)(10) elections above).

(b) **Allocation of Purchase Price**: The allocation of the purchase price is a crucial planning factor in a purchase of assets. Since corporations do not have the benefit of favorable tax rates for capital gains, the C corporation seller is generally not overly concerned with the allocation. The buyer, on the other hand, wants to allocate as much of the purchase price as it can to those assets, such as inventory and depreciable property, that will generate deductions more quickly.

Because of this lack of conflict between the buyer and the corporate seller, any allocation is suspect, and the Internal Revenue Service is likely to examine more closely the parties' allocations. Further, as noted above, Code section 1060 must be considered. Where the parties cannot agree to an allocation of the purchase price among the assets being purchased, each party is free to allocate the purchase price as deemed appropriate. The Internal Revenue Service, however, is not required to accept the allocation, whether or not it is agreed to by the buyer and the seller. Under Code section 1060, the Internal Revenue Service will use a "seven-tier" approach to allocate the purchase price to the acquired assets. Under this approach, the purchase price is allocated to seven different asset classes (to the extent of the fair market value of the acquired assets in each such class) in the following order of priority: Class I: cash, savings and checking accounts and other cash equivalents; Class II: actively traded personal property, as defined in Code section 1092(d), certificates of deposit and foreign currency; Class III: accounts receivable and most debt instruments, mortgages and credit card receivables; Class IV: stock in trade of the taxpayer or other property of a kind that would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of trade or business; Class V: all assets not in classes I, II, III, IV, VI or VII; Class VI: all Code section 197 intangibles except goodwill or going-concern value; and Class VII: goodwill and going-concern value. Where the purchase price is less than the fair market value of the assets at any tier, the price is allocated among the assets in that tier based upon their relative fair market values.

(c) **Deferred Payments**: As with a sale of stock, where the purchase price for a sale of assets will be paid over time, issues arise concerning when the gain will be reported. Where assets are sold for an installment obligation, if the installment method is available, gain generally will be deferred until the payments are actually received or due. Further, the rules on original issue discount and imputed interest, discussed earlier, are equally applicable to the sale of assets.

One primary difference, however, occurs when assets subject to depreciation recapture are sold on the installment basis. In that event, the depreciation recapture is reportable as ordinary income and is immediately recognized. This is true even though no portion of the sales price is received or due in the year of sale. A similar result occurs with respect to the sale of appreciated inventory.

As with the sale of stock, depending upon the sales price of the assets, the seller may be required to pay interest on the taxes that are deferred by using the installment method and may be subject to immediate taxation if the installment obligation is pledged to secure an indebtedness.

3. Contingent Sales Price

In many situations, the parties may agree to a contingent sales price. For example, because of contingent liabilities that exist, or other factors that may affect the value of the assets or stock being purchased, the contract may provide for a holdback of a portion of the purchase price. In other cases, the parties may be unable to arrive at a value for the business if the future income cannot be accurately estimated, or if the seller demands a higher price based upon earnings capacity and the buyer is unwilling to pay that price until the earnings are actually realized. Contingent sales price arrangements such as these raise a number of considerations.

Where the contingent payments will be treated as received in exchange for the sale of property, they fall within the ambit of the installment sale provisions. If the installment method is available, and if there is a known, maximum contingent payment, the installment sale provisions will be applied using the maximum amount to calculate the gross profit percentage. If less than the maximum amount is received in the future, an appropriate adjustment will be made to the gain to be reported at that time. Where the maximum sales price is indefinite, but is payable over a fixed period of time, the basis for the assets sold is recovered over that period of time. The basis will be recovered ratably unless payments to the seller are determined under a changing formula, in which case the recovery will be tied to the formula. If neither a maximum price nor a fixed period over which the price is to be paid is set forth in the agreement, then the seller is required to recover his basis over a period of 15 years.

From the buyer's standpoint, the issue is how the basis of each asset purchased is determined. The buyer cannot include a contingent payment in the basis of purchased assets until the payment is actually made or accrued. If the contingent payments are received after the asset has already been sold, this portion of the payment would be deductible as a loss, either ordinary or capital, depending upon the nature of the asset sold.

Where it is clear that the contingent payment will at least equal the fair market values of the inventory, receivables and depreciable assets being purchased, the inability to use the contingent payment as part of the basis of those assets would mean that more income will be realized in the interim if those assets are sold. The fact that an offsetting deduction may be available in the future is of little solace to the buyer if he is faced with an immediate tax payment. The buyer may wish to insist that the sales contract provide for a definite price for the inventory, receivables and depreciable assets, or that the contingent payment be allocated specifically to ensure that the maximum basis can be given immediately to inventory, receivables and depreciable assets.

4. The Medicare Tax

As noted above, starting in 2013, taxpayers who are individuals, estates or trusts may be subject to an additional 3.8% tax (the Medicare Tax) imposed on certain items of gain arising from the sale of an interest in a business or, when the business is operated through a flow-through entity such as a partnership or an S corporation, on the sale of the assets of the business. This tax is imposed on the lesser of (i) the taxpayer's "net investment income" or (ii) the excess of "modified adjusted gross income" (MAGI) over a specified threshold amount ($250,000 for married couples filing jointly (or surviving spouses), $125,000 for married couples filing separately and $200,000 in all other cases). MAGI generally equals adjusted gross income increased for certain foreign earned income items and related housing costs for taxpayers who work and earn income abroad. The Medicare Tax is an additional tax on net investment income and is not deductible when computing the taxpayer's regular federal income tax or AMT.

Net investment income generally consists of three categories of income: (i) investment-type income (e.g., interest, dividends, rents and royalties) other than such income that is derived in a trade or business that is not a Passive Business (as defined below), (ii) gross income derived from a Passive Business, and (iii) net gain from the sale of property other than property held in a trade or business that is not a Passive Business. For this purpose, a Passive Business generally is (A) a trade or business that is a "passive activity" as to the taxpayer (generally, one in which the taxpayer does not materially participate) or (B) a trade or business consisting of the trading of financial instruments or commodities.

In determining the amount of net investment income and MAGI, the normal federal income tax rules generally apply. Thus, for example, any gain that is not recognized or that is deferred for federal income tax purposes (e.g., eligible consideration received in a reorganization or gain on an installment sale) is generally not taken into account for purposes of the Medicare Tax in the year of sale.

Net investment income will generally include a taxpayer's net gain from the sale of stock or other equity interests in a business. However, with respect to net gain derived from the sale of an interest in an entity that is classified as a partnership or an S corporation for federal income tax purposes, there is an adjustment to the gain that will be treated as net investment income. Pursuant to proposed regulations, this adjustment is generally equal to the gain that would flow through to the selling taxpayer and be excluded from net investment income if the partnership or S corporation engaged in an arm's-length sale of all its assets. Thus, for a partner or S corporation shareholder who is active in the entity's trade or business, any gain on the sale of stock or other equity interest that is attributable to the partner's or shareholder's portion of the gain on property used in that trade or business (other than a trade or business consisting of the trading of financial instruments or commodities) will escape the Medicare Tax.

For purposes of the Medicare Tax, amounts treated as net gain from the sale or exchange of property under general federal income tax principles can get caught in the net of the Medicare Tax. Thus, for example, if a Code section 338(h)(10) election (discussed above) is made with respect to the purchase of stock in an S corporation, the selling shareholders could have net investment income from both the deemed sale of assets arising from the election and any net gain resulting from the deemed liquidation of the S corporation.

Given the complexity associated with the Medicare Tax, business owners should consult a tax professional with regard to the application of this tax.

Nontaxable Transactions

Although gain is generally taxable whenever a taxpayer sells, exchanges or otherwise disposes of property, the Code provides many exceptions to this general rule of taxation. This section will outline one group of such exceptions: the corporate reorganization provisions of Code section 368.

The corporate reorganization provisions are extremely complex, even by the standards of the Code, and require strict adherence to technical requirements mandated by the statute and related regulations, as well as additional judicially developed standards. Therefore, where a tax-free corporate acquisition is contemplated, experienced legal counsel is essential.

1. Nontaxable Corporate Reorganizations in General

Usually, a seller receives cash or cash equivalents in a taxable sale and generally must pay tax when the sale is closed. On the other hand, a seller in a nontaxable corporate reorganization generally receives stock of the acquiring corporation (or stock of the parent of the acquiring corporation) rather than cash. Because the seller in a corporate reorganization has not "cashed out" of his investment but has merely transferred his original investment interest from the target corporation into the acquiring corporation, the Code does not tax the gain at the time of the exchange. However, once stock of the acquiring corporation is sold, normal tax consequences result. Therefore, gain on the initial exchange is not permanently excluded from income but merely postponed until such time as the seller's continuing investment in the acquiring corporation is liquidated. The result is the same for purposes of the Medicare Tax discussed above.

This "continuity of interest" principle is the heart of the nontaxable corporate reorganization provisions and is the reason that the Code allows a deferral of tax on the reorganization exchange. Provided the sellers receive the necessary equity interest in the acquiring corporation, and provided the technical requirements of the Code are satisfied, the following basic tax consequences will result:

(a) The shareholders of the target corporation may exchange their stock for stock of the acquiring corporation without recognition of gain or loss;

(b) The target corporation recognizes neither gain nor loss on a transfer of its assets for stock of the acquiring corporation; and

(c) The tax attributes (e.g., net operating loss carryforwards, basis of depreciable assets, etc.) of the target corporation are inherited by the acquiring corporation.

2. Types of Nontaxable Acquisitive Reorganizations

As in the case of a taxable transaction, a nontaxable acquisitive reorganization may be structured as an acquisition of stock from the corporate shareholders in exchange for the acquiring corporation's stock (a "B" reorganization), or as an acquisition of assets from the target corporation in exchange for the acquiring corporation's stock (an "A" reorganization or a "C" reorganization). Many of the stock versus asset-purchase considerations in the taxable-transaction context discussed earlier also apply in structuring a nontaxable acquisition as an asset or stock acquisition. The three basic forms of acquisitive reorganizations are outlined below.

(a) **"A" Reorganization**: An "A" reorganization, defined in Code section 368(a)(1)(A), is a statutory merger or consolidation. In a merger, the corporate enterprise of one corporation (the target corporation) is absorbed by another corporation (the acquiring corporation). A consolidation involves the combination of two or more corporations into a newly created corporate entity. Usually, "A" reorganizations are structured as mergers.

The merger occurs by the transfer, by operation of state law, of the assets and liabilities of the target corporation to the acquiring corporation, with the simultaneous disappearance of the target corporation as a separate legal entity. Pursuant to the plan of merger adopted by the acquiring and target corporations, shareholders of the target corporation generally receive stock of the acquiring corporation in exchange for their stock interest in the target corporation.

The primary advantage of an "A" reorganization over either a "B" or a "C" reorganization is the flexibility of the type of consideration that may be transferred to the target corporation's shareholders in exchange for their stock. Nonvoting stock, securities or even cash consideration may be utilized, provided at least 40% of the total consideration transferred consists of stock of the acquiring corporation. Generally, to the extent that consideration other than acquiring corporation stock is received, capital gain will be recognized. Therefore, an "A" reorganization may be utilized where the majority shareholder of the target corporation desires stock of the acquiring corporation but a minority shareholder wants cash. In such circumstances, the minority shareholder generally will pay capital gains tax (and potentially the Medicare Tax) on the cash he receives, but the majority shareholder generally will pay no tax on his receipt of stock of the acquiring corporation.

To avoid exposure to the liabilities of the target corporation, an "A" reorganization may also be effected by utilizing a subsidiary as the acquiring corporation. For example, Corporation P contemplates a purchase of Corporation T, but does not want to expose its assets to contingent or undisclosed liabilities of Corporation T. Corporation P may avoid exposure to Corporation T's liabilities by forming a subsidiary, Corporation S, and then merging S into T or T into S, with T's shareholders receiving Corporation P stock. Such use of a corporate subsidiary, particularly when the merger involves the merger of the subsidiary into the target corporation, involves meeting additional requirements to obtain status as a reorganization under the Code but is always an alternative that buyers should consider. In recent years, subsidiary mergers have often involved wholly owned limited liability company subsidiaries of the acquiring corporation. This technique can provide the same protection from exposure to the liabilities of the target corporation with fewer tax hurdles to overcome than when corporate subsidiaries are used.

(b) **"B" Reorganization**: A "B" reorganization, defined in Code section 368(a)(1)(B), is the acquisition of stock of the target corporation in exchange solely for the acquiring corporation's voting stock (or voting stock of the acquiring corporation's parent), provided that immediately after the reorganization the acquiring corporation owns at least 80% of the target corporation. "B" reorganizations differ from "A" or "C" reorganizations in that the exchange transaction is between the acquiring corporation and the shareholders of the target corporation. In order to qualify as a "B" reorganization, only voting stock may be given as consideration to the target corporation's shareholder.

The principal advantages of a "B" reorganization include: (i) no appraisal rights for dissenting shareholders; (ii) preservation of the corporate identity of the target corporation; and (iii) lower transaction costs than when assets are acquired. The principal disadvantages include: (i) the very strict statutory requirements and (ii) the fact that dissenting minority shareholders are not eliminated and may prove to be a disruptive influence.

(c) **"C" Reorganization**: Generally, a "C" reorganization, defined in Code section 368(a)(1)(C), is the acquisition of substantially all of the assets of one corporation, solely in exchange for the acquiring corporation's voting stock (or voting stock of the acquiring corporation's parent). In addition, the acquiring corporation may assume some or all of the target corporation's liabilities. Unlike a "B" reorganization, in a "C" reorganization, the acquiring corporation under some circumstances may transfer a limited amount of cash or other consideration in addition to its voting stock. To satisfy the "substantially all of the assets" requirement of a "C" reorganization, the Internal Revenue Service requires that at least 90% of the fair market value of the net assets and 70% of the fair market value of the gross assets of the target corporation be acquired. The target corporation must liquidate following the transfer of its assets in a "C" reorganization.

The principal advantages of a "C" reorganization include the following: (i) the exposure to liabilities of the target corporation is limited to liabilities expressly assumed; (ii) in some circumstances, consideration other than voting stock may be utilized; and (iii) unwanted assets need not be acquired as long as substantially all of the assets are acquired.

3. Advantages and Disadvantages to Seller

The seller's principal advantage in a nontaxable reorganization is that tax on the exchange generally is deferred until such time as the property received in the exchange is sold. This is of particular advantage to an elderly shareholder, since if the new stock is held until death, the seller's heirs will generally receive a "step-up" in the cost basis of the new stock, thereby potentially eliminating the entire income tax on the sale of the business.

The seller's principal disadvantage is that, since he receives stock in the exchange, he remains an investor in the acquiring corporation. If the acquiring corporation's business declines, the value of the tax-deferred consideration received by the seller in the reorganization exchange could depreciate significantly. Further, if the acquiring corporation is closely held, the seller may be "locked into" the acquiring corporation (possibly as a minority shareholder) indefinitely.

Selling shareholders should be aware that “nonqualified preferred stock” is treated as taxable “boot” (i.e., nonstock consideration) in an otherwise tax-free corporate reorganization. Note, however, that receipt of nonqualified preferred stock will be taxable boot only if received in exchange for stock other than nonqualified preferred stock. “Preferred stock” is stock that is limited and preferred as to dividends and does not participate in corporate growth to any significant extent. Preferred stock will be considered “nonqualified preferred stock” if, at the time of issuance, any of the following apply: (i) the shareholder has the right to require the company or a related person to redeem the stock; (ii) the company or a related person is required to redeem the stock; (iii) the company or a related person has the right to redeem the stock, and it is more likely than not that such right will be exercised; or (iv) the dividend rate on the stock varies in whole or in part (directly or indirectly) with reference to interest rates, commodity prices or other similar indices. This rule applies regardless of whether the varying rate is provided as an express term of the stock (for example, adjustable rate stock) or as a practical result of other aspects of the stock (for example, auction rate stock).

Nonqualified preferred stock generally is treated as boot only at the shareholder level and still is considered stock for other tax purposes, including determining whether the overall transaction qualifies as a tax-free reorganization. Note, however, that the Treasury Department has authority to prescribe the treatment of nonqualified preferred stock under other provisions of the Code. Thus, unless future regulations provide otherwise, nonqualified preferred stock that has voting rights will be treated as “voting stock” for purposes of qualifying a transaction as a “B” or a “C” reorganization, and otherwise as “stock” for purposes of qualifying a transaction as an “A” reorganization, even though such stock may be taxable as boot at the shareholder level.

4. Advantages and Disadvantages to Buyer

From the buyer’s viewpoint, the principal advantage of a nontaxable reorganization is that the buyer uses its own stock rather than limited working capital to finance the acquisition. Further, the acquiring corporation may secure the carryover of desirable tax attributes from the target corporation, such as a net operating loss carryforward, subject to certain limitations imposed by the Code (see below). The primary disadvantages to the buyer are dilution of the equity interest of its prereorganization shareholders and the carryover of disadvantageous tax attributes from the target corporation, such as low basis in depreciable assets.

Carryover of Tax Attributes

A primary concern of the buyer of a business may be whether the tax attributes of the seller will be available to him after the sale. The buyer will be particularly concerned if the business has net operating loss carryovers available. The buyer will likely want to structure the purchase to take advantage of those carryovers, and the seller may want to receive a higher price if those carryovers can be passed on to the buyer.

The federal income tax laws contain significant restrictions on the ability of the buyer to take advantage of a seller’s tax attributes, and, in particular, net operating loss carryovers. There is an avowed statutory purpose to prevent trafficking in net operating loss carryovers. To preserve those carryovers, among many other restrictions, the transaction must be structured so that the purchased corporation continues its historic line of business.

1. Purchase of Assets

On the taxable sale of the assets of a business, none of the business's tax attributes will pass to the buyer. The buyer obtains a new basis for the assets acquired and may use whatever depreciation methods are available to him under the Code. The purchased corporation's tax attributes, such as net operating loss carryovers, earnings and profits, method of accounting, and method of accounting for inventory, will not pass to the buyer.

2. Purchase of Stock

The federal tax laws limit the availability of net operating loss carryovers following a change in ownership of the corporation. These rules are complicated, and experienced counsel is strongly recommended to ensure that the planned availability of a net operating loss carryover will actually be realized. Under the federal tax laws, if more than 50% in value of the loss corporation's stock has been sold over a specified period, the amount of income each year that can be offset by the corporation's net operating loss carryover generally is limited. The limitation amount is equal to the value of the loss corporation (i.e., the target corporation) multiplied by the federal long-term tax-exempt interest rate. The federal long-term tax-exempt interest rate is a rate published monthly by the Internal Revenue Service, similar to the interest rates it sets under the original issue discount rules.

3. Corporate Reorganizations

A similar rule to the rule that applies to the purchase of stock also applies in the case of corporate reorganizations. In the case of an "A," "B" or "C" reorganization, if more than 50% in value of the target corporation is now owned by the acquiring corporation, the income that may be offset each year by the net operating loss carryover is limited. As in the case of a stock purchase, the limitation amount is equal to the value of the target corporation multiplied by the federal long-term tax-exempt interest rate.

Chapter 6

Special Concerns for Public Companies

In an acquisition involving the issuance of securities, the securities law consequences of the chosen form of the transaction must always be considered. The principle is that all "securities" (which may include promissory notes and other consideration not generally thought of as securities) to be issued in acquisitions must be registered under the 1933 Act and applicable state securities laws unless an exemption from registration is available. This chapter focuses upon the securities law aspects of acquisitions involving a publicly held company. Issues such as public announcements, SEC requirements and state requirements will be considered.

Public Announcements

The failure of a public company to disclose an important transaction or the making of a misleading disclosure can prove to be injurious to a company and its stockholders and give rise to claims against officers and directors. Preannouncement "leaks" can result in substantial gains by "insiders" who misappropriate material information for their own ends. Premature disclosure may mislead investors and possibly jeopardize a transaction.

Of the myriad of federal laws, rules and regulations governing the issuance or sale of securities, the most important as far as corporate publicity is concerned is Rule 10b-5. Promulgated under the Securities Exchange Act of 1934 (the 1934 Act), this provision was first construed to subject to liability any corporate "insider," such as an officer, director, employee or tippee, who engaged in a securities transaction while in the possession of material information that was not disclosed, inadequately disclosed or disclosed in a misleading manner. Subsequently, the scope of this rule was broadened to subject to liability a corporate officer who was instrumental in the promulgation of a misleading press comment even though insider trading was not involved. State securities laws often include provisions that are substantially identical to those of Rule 10b-5. The liabilities involved in violating Rule 10b-5 or a state corollary may be substantial.

If the securities of either of the parties are listed on a national securities exchange, the regulations of the exchange should be reviewed to determine the nature of its disclosure requirements. The purpose of these regulations is to ensure timely disclosure of any information that may affect the value of the securities traded on the exchange. Such regulations are more specific, and often more stringent, with respect to the timing and nature of the information to be disclosed than are the applicable state and federal provisions. Violation of exchange guidelines can result in suspension of trading or, in extreme cases, the delisting of the subject securities, even though no other regulations have been contravened.

SEC Requirements

With respect to corporate acquisitions involving the issuance of securities, the nature of the transaction will affect the applicability of the registration requirements, rules and exemptions under federal law. In structuring a transaction, one must be concerned with compliance with the federal securities laws, the ability of the sellers to resell securities received as consideration for the transaction and the expense involved in resales.

Rule 145 promulgated under the 1933 Act generally requires the registration of securities issued in the following transactions: (a) statutory mergers or consolidations in which the plan is submitted to a vote of shareholders (except cases in which the sole purpose of the merger is to change the issuer's corporate domicile), (b) transfers of assets in consideration for the issuance of securities if the securities are to be distributed by the transferor to its securityholders and (c) reclassifications involving the substitution of one security of a corporation for another security of the same corporation. Registration is not required if the transaction can be accomplished pursuant to an exemption. Voluntary exchanges under section 3(a)(9) of the 1933 Act in which the same issuer exchanges securities with its securityholders and no remuneration is involved, certain exchanges supervised by courts and agencies as provided in section 3(a)(10) of the 1933 Act, exchanges involving only intrastate offerings and exchanges that amount to a private offering under section 4(2) or Regulation D of the 1933 Act are examples of exemptions that may be available in connection with the transaction.

Since the number of stockholders of a publicly held company precludes reliance upon the private offering exemption, a stock-for-stock acquisition of such a company requires registration of the offered securities unless some other exemption from registration is available. Cash tender offers are not required to be registered under the 1933 Act, but compliance with the tender offer and notification requirements under section 14(d) of the 1934 Act is necessary.

Issuers engaged in a continuous program of acquisitions may wish to register a large number of shares for the "shelf" and, at the time of each transaction that would otherwise require registration, update the shelf prospectus by means of a post-effective amendment. In some instances, this approach may prove less costly than the preparation of a registration statement for each transaction. Moreover, an issuer with a shelf registration program can offer the advantage of registration to nonaffiliate acquired-company shareholders without incurring significant added expense. If, however, the acquired company is registered under the 1934 Act or its acquisition is material to the acquiror under specific SEC rules, a shelf registration statement may prove impractical for the transaction because of the revisions that would be required to be provided in the prospectus of all of the disclosures required by the applicable rules.

Blue Sky Requirements

The great majority of states have enacted legislation that provides for the regulation of securities and dealers in order to protect the interests of the purchasing public. The securities laws of the states whose residents will receive securities in connection with a transaction will apply.

If a transaction is of such a nature or a security is of a specified kind such that no regulation is considered necessary, exemptions from registration are provided. For example, the National Securities Markets Improvements Act of 1996 preempted state registration requirements for securities listed or authorized to be listed on the New York Stock Exchange, the American Stock Exchange or the NASDAQ Stock Market. Additionally, a number of states consider a merger, consolidation or sale of assets requiring stockholder approval under corporate law to be a transaction that does not require regulation. Accordingly, such a transaction may be exempted from the registration requirements of the applicable state securities law. Such exemptions may be found in the definition of a sale or included in a special category of exempt transactions. If neither a definitional exclusion nor a transactional exemption is available, registration of securities may still be unnecessary because the issuing corporation is under the supervision of federal or state bodies such as banking, insurance or public utility commissions, or because the securities are listed on a recognized stock exchange, thus affording the requisite public protection. With respect to transactions involving sales of stock, many of the states provide exemptions for sales of shares to buyers who participate in the management and control of the corporation. Generally, these states maintain that such a transaction is not a sale of a security but rather a sale of a business.

The state blue sky laws and the rules and provisions promulgated thereunder provide a comprehensive body of law regulating both the securities to be sold and the persons participating in the sales. Violations of the provisions of the statutes can result in rescission of sales and criminal penalties.

Chapter 7

Corporate Actions Required

This chapter discusses the corporate action that must be taken by both the buyer and the seller in connection with two methods of effecting an acquisition: the purchase by the buyer of all or a controlling interest in the stock of the seller and a sale of all or substantially all of the assets of the seller to the buyer. Appraisal rights for dissenting stockholders are addressed as well.

Stock Transactions

In a transaction in which one company acquires the stock of another from its shareholders, the company being acquired is usually not a party to the transaction. Accordingly, the target corporation will not be required to take any corporate action to authorize the transaction. To the extent that any of the selling stockholders are corporations, these entities will have to take all necessary corporate action to authorize the sale of these shares.

From the viewpoint of the buyer, the only corporate action required is authorization by its board of directors. An executive committee that has been granted the maximum authority permitted by law will usually have the authority to approve such a transaction. Approval by the stockholders of the buyer is generally not required.

Sale of Assets

Almost all jurisdictions require director and stockholder approval (the requisite percentages vary) for the sale of "all or substantially all" of a corporation's assets. There are, however, a number of significant distinctions, both in the language of the state statutes and in the ways the courts have interpreted them. The principal statutory distinction is that some statutes exclude sales made in the regular course of business, while others do not.

Another legal issue that has arisen under the statutes is whether the term "substantially all of the assets" is to be determined strictly on a quantitative basis, which focuses on the percentage of the total assets being sold, or whether a qualitative standard will also be implied, which involves looking into the importance of the assets being sold in relation to the business of the selling corporation. The courts have offered no definitive guidelines in this regard. In some jurisdictions, the courts have applied a strictly quantitative test, while others have applied both a qualitative and a quantitative standard. Further, the courts that have applied a quantitative standard have differed concerning how high a percentage of the company's total assets must be sold before the "substantially all" test is triggered. Courts in some jurisdictions have suggested that a sale of over 50% of the total assets may trigger the statute, while most others have indicated that a much higher percentage will be required. In view of the fact that the states differ with respect to the nature of the transaction requiring director and stockholder approval for a sale of assets, careful attention should be paid to the statutes and case law governing this issue in the seller's state of incorporation.

On the buyer's side, the corporate action required is generally identical to that required to be taken in a stock transaction.

Other Approval Requirements

In some instances, it might be necessary to amend the charter of the buyer to authorize additional shares or a new class of stock. This situation could arise if the consideration being delivered by the buyer includes stock and either the number of authorized shares is insufficient or a new or special class of stock is to be issued that is not authorized in the buyer's charter. Such an amendment requires authorization by the board of directors plus the approval of the holders of a specified percentage of the outstanding shares entitled to vote. Stockholder approval of the buyer may also be required if additional shares are to be issued in the transaction and these shares are of a class listed on certain securities exchanges. Both the New York Stock Exchange and NASDAQ rules require that a listed corporation seeking to issue more than 20% of its shares obtain shareholder approval of the transaction as a prerequisite to the listing by the exchange of additional shares. If no additional shares of the listed class are to be issued, shareholder approval on the part of the listed company is not required under the exchange rules.

The approval of bond holders of a corporation is typically not required in connection with a merger or sale of all or substantially all of its assets. Many debt instruments, however, particularly those issued in connection with institutional financing, contain provisions requiring the debtor to apply proceeds from an asset sale to the business or to offer to redeem the debt.

Appraisal Rights

The statutes of most states provide that dissenting stockholders of the seller in a transaction involving a merger or sale of assets who dissent from the transaction may obtain the fair value of their stock in cash in lieu of the consideration provided for in the transaction, by following the procedures set forth in the statutes. The appraisal procedures set forth in the statutes (which vary from state to state) generally must be followed meticulously in order to perfect the appraisal right.

Most states provide that a stockholder who has perfected his appraisal rights is entitled to receive the "fair value" of his stock in cash. However, with the significant exception of New York, most state statutes do not define fair value or how it is to be determined. Issues with respect to the fair value of the shares have been left to the courts. The courts of the various jurisdictions have considered diverse factors in determining fair value of the stock and have differed on the weight to be given to each of these factors. In most cases, however, the principal elements used in a determination of the fair value of the stock have been the market value (when there is an active market for the stock of the company in question), so-called investment value, and net asset value, with the principal weight generally being given to market value.

Chapter 8

Employee Benefit Plans

The growing importance of employee benefit issues in corporate transactions of all types, whether they are mergers, acquisitions, divestitures or liquidations, cannot be disregarded or left until the last minute prior to closing. Indeed, the presence of pension liabilities under single-employer pension plans and multiemployer pension plans not only may affect the economics and structure of the transaction but may, in some cases, influence whether or not the transaction will occur at all.

Documentation

It is very important that both parties to a proposed transaction gather, at the outset, copies of all employee benefit plan documents, union contracts, prior disclosures to participants, Internal Revenue Service annual report forms (Form 5500 series) and funding vehicles relating to such plans. In the case of tax-qualified retirement plans, it is important to gather and scrutinize all relevant Internal Revenue Service determination letters concerning such plans and actuarial reports for defined benefit plans. Because all of the foregoing can have a material impact on the desirability and structure of a transaction, this must be done at the outset.

Single-Employer Pension Plans

Under present law, if a single-employer pension plan is terminated and the assets of the plan are not sufficient to pay for all vested and unvested benefits accrued under the plan, the employer maintaining the plan will be liable to the Pension Benefit Guaranty Corporation (PBGC) for the amount of the shortfall, but not to exceed the sum of: (1) the lesser of the amount of unfunded benefits or 30% of the net worth of the employer (including any business that is under common control with the employer); and (2) the excess of 75% of the unfunded benefits over 30% of the net worth of the employer. Failure to pay any such liability may result in a lien against all assets of the employer and/or its controlled group.

1. Assumption of Pension Liabilities

The successor corporation or corporations in a corporate transaction will inherit any single-employer pension liability of the predecessor corporation or corporations if the transaction is a reorganization involving a mere change in identity, a liquidation into a parent or a merger or consolidation of a division. In the case of a sale of stock, the target corporation will continue to be subject to any liability previously accrued. A buyer of assets generally will not incur liability by reason of the seller's termination of a plan, whether prior to or subsequent to the purchase of assets, unless a principal purpose of the transaction is to evade liability associated with a defined benefit pension plan; on the other hand, a seller will sometimes desire to terminate his plan in order to recapture assets in excess of those needed to pay off all accrued benefits. If a buyer assumes a pension plan of the seller, the buyer will incur potential liability for himself and any other members of his group, which will be realized if the plan is subsequently terminated before all accrued plan benefits are fully funded.

2. Continuation of Liabilities

Generally, if a buyer continues a plan maintained by a seller, the seller should incur no liability by reason of a transaction or the buyer's subsequent termination of the plan. However, if the buyer is not financially sound at the time of the transaction, the PBGC may assert that the sale is a fraud, with the seller remaining liable.

3. Assessing Liabilities

In assessing potential liability for termination of a pension plan in connection with a proposed corporate transaction, one should be aware that the value of accrued benefits for plan termination purposes will probably differ from the value of vested accrued benefits reflected in an actuarial report based on the plan as a going concern. The reason is that different factors and assumptions are used by actuaries for the plan as a going concern, as contrasted with those used by the PBGC for plan termination purposes.

Finally, it should be noted that such liabilities do not normally apply to defined contribution plans such as profit-sharing plans and employee stock ownership plans.

Multiemployer Pension Plan Liability

1. Generally

A multiemployer pension plan is a defined benefit pension plan to which two or more unrelated employers contribute pursuant to collective bargaining agreements. In the event an employer makes a "complete withdrawal" from such a plan or reduces its level of participation in the plan to the extent of a "partial withdrawal," the employer is required to pay its proportionate "share" of the plan's unfunded, vested liabilities.

Under many multiemployer plans, a withdrawing employer may incur liability that is many times greater than its regular annual contributions to the plan. Accordingly, potential withdrawal liability should be estimated very early in any negotiation of a corporate transaction. In most cases, it is possible to obtain in advance from a multiemployer plan either an estimate of withdrawal liability or the necessary factors that the advisers to an employer may apply to the employer's contribution record in order to provide an estimate of such liability.

A "complete withdrawal" occurs when an employer permanently ceases to have any obligation, for whatever reason, to contribute to the multiemployer pension plan (for example, if the bargaining representative is decertified by its members) or permanently ceases covered operations. Even if an employer does not completely withdraw from the plan, it may, under certain circumstances, incur "partial withdrawal liability" if it discontinues contributions with respect to a particular bargaining unit or facility or if it incurs a substantial reduction (i.e., 70 percent or more) in overall contributions.

2. Sale of Assets Exemption

If a sale of assets results in a seller's complete withdrawal or partial withdrawal from a multiemployer plan, the seller will incur withdrawal liability even though the buyer is obligated to continue to make contributions to the plan on the same basis as the seller. However, a special statutory exemption provides that such liability will not be incurred by the seller in connection with a sale of all or a portion of its assets to an unrelated buyer if all of the following conditions are met:

(a) After the sale, the buyer is obligated to make contributions to the plan with respect to the buyer operations for substantially the same number of contribution base units (e.g., hours worked) for which the seller was obligated to contribute prior to the sale.

(b) The buyer posts a bond or establishes an escrow in an amount equal to the seller's annual rate of contributions for the operations being sold.

(c) The contract for sale specifically provides that, if the buyer withdraws from the plan within five plan years following the sale, the seller will be secondarily liable for the amount of the withdrawal liability that he would have incurred at the time of the sale but for the exemption.

If the sale-of-assets exemption is used, the buyer will be treated as if he had made contributions to the plan with respect to operations that he purchases for the year of the sale and the four preceding years equal to the seller's contributions for those years. Because most methods of calculating withdrawal liability are based on an employer's proportionate share of contributions, the buyer's liability upon a subsequent withdrawal will ordinarily be increased if the sale-of-assets exemption has been used.

The sale-of-assets exemption does not assure the seller that he will never incur withdrawal liability for the sold operations. It merely provides that no liability will be incurred solely on account of the sale. If the sale represents all of the seller's operations covered by the applicable plan and the buyer does not withdraw for at least five years, the seller will not incur liability under the plan. However, if the sale represents only a portion of the operations covered by the plan, the seller may incur liability attributable to those operations by reason of a prior or subsequent partial withdrawal from the same plan or a subsequent complete withdrawal.

Use of the exemption should be carefully assessed in each case for appropriateness. If a sale of assets would otherwise result in a complete withdrawal or a partial withdrawal, it will generally be in the interest of the parties to include the sale-of-assets exemption. The amount of liability the seller is relieved of by the exemption will generally exceed the additional liability incurred by the buyer. Under certain circumstances, however, the sale-of-assets exemption might not be appropriate. For example, where the seller's withdrawal liability would be eliminated as a de minimis amount or where the sale is not expected to result in immediate or subsequent complete or partial withdrawal liability to the seller, use of the exemption would be inappropriate. In addition, a buyer may be concerned about the exemption's precluding his utilization of various exemptions upon a subsequent withdrawal or about the potential for increases in the liability resulting from poor investment returns or subsequent withdrawals by insolvent employers.

If the sale-of-assets exemption is appropriate, the buyer will often seek to be made whole for any additional cost or liability he may incur because of the exemption. This is often done either through a holdback of the purchase price or by an indemnity agreement.

3. Sale of Stock

Generally, a sale of stock should result in no multiemployer liability, since the employer will continue to be obligated to contribute to the plan. This applies even when a parent sells the stock of a subsidiary with a resulting reduction in the controlled group's obligation to the plan.

4. Importance of Transaction Structure

For the reasons discussed above, the structure of a transaction as either a sale of stock or a sale of assets may significantly affect the individual and aggregate liabilities of the parties to the transaction. Because of the potential reduction in aggregate liability, the sale of assets will often be the preferred structure.

Other Pension Issues

1. Miscellaneous Problems

In addition to potential liability for termination of a single-employer pension plan or a withdrawal from a multiemployer pension plan, each party in a corporate transaction should review the possibility of other liabilities, including those relating to plan compliance with Code requirements and the requirements of the Employee Retirement Income Security Act of 1974, as amended (ERISA). In reviewing various documents gathered at the outset of a proposed transaction, care should be taken in advance to determine what limitations might be placed on the ability of the parties to negotiate with respect to the involved plans. For example, liabilities may arise by reason of errors in the administration of a pension plan, and union contracts may provide that a pension plan may not be terminated prior to the expiration of the contract. The plan cannot be terminated without sufficient assets to pay all benefits unless the plan sponsor and each member of its controlled group is financially distressed and the termination is approved by the PBGC. Furthermore, group annuity contracts issued by insurers to fund retirement plans normally impose significant penalties if all or a portion of a plan's assets is withdrawn from such a contract before its expiration.

An issue of emerging importance is retiree health and hospitalization coverage. In an asset sale, the buyer normally will resist assuming liability for such coverage because such retirees were never in its employ. Termination of such coverage by the seller in any type of sale may also result in many legal difficulties.

2. Funding Deficiency

Any liability for a funding deficiency or excise tax for failure to meet any minimum pension funding obligations under the Code stays with a target corporation in a sale-of-stock transaction, but generally not in the case of an asset sale in which the buyer assumes the seller's pension plan (unless the funding deficiency results in the creation of a lien on the seller's assets).

In this regard, funding obligations may vary depending upon funding methods and actuarial assumptions utilized. Thus, annual contributions may be significantly affected if a buyer assumes a seller's plan and changes the funding method and assumptions in order to make them consistent with the buyer's other plans.

3. Effect on Qualification

A corporate transaction may also affect the future qualification of a plan of the buyer maintained prior to the transaction or assumed by the buyer pursuant to the transaction. A buyer of stock or a buyer of assets who assumes a seller's plan will also be concerned as to whether the seller's plans are qualified on and after the transaction date because of the changed employee makeup. The plan could be disqualified, for example, because of discrimination in favor of highly paid employees even though the Internal Revenue Service has previously issued a determination letter stating that the plan qualifies.

4. Deductions for Past Service Costs

An issue that frequently comes up in asset sales in which the buyer assumes the pension plan maintained by the seller is whether the buyer's contributions after the sale will be deductible with respect to unfunded past service liability under the seller's plan as of the date of sale. Treasury regulations specifically provide that, in computing the cost of past service credits under such a plan, the buyer may include the cost for the period of service with the seller and that contributions will be deductible by the buyer even if the plan is exclusively for the benefit of former employees of the seller. This is contrary to other sections of the Code requiring that liabilities assumed by the buyer be treated as part of the purchase price of the assets acquired and allocated among those assets.

Chapter 9

Documentation

Drafting a contract of sale is more than merely committing to writing what the parties have already agreed upon. Certain legal problems inherent in any acquisition may or may not have been raised in preliminary negotiations. These concerns must be addressed and resolved in the contract for sale. Additionally, many of the essential terms and conditions of the transaction that are to be included in the contract have never been discussed or even considered by the principals prior to the preparation of the contract. It is because of these factors that no meeting of the minds is ever really achieved until there is a final agreement on the contract of sale. This chapter addresses certain aspects of the contract for sale, including representations and warranties and covenants. Other issues, including indemnification and other disclosure techniques, are considered as well.

The Acquisition Agreement—In General

The terms warranties, representations, covenants and conditions are sometimes used interchangeably, although each has a different meaning and a different purpose. Warranties are promises that existing or future facts are or will be true. Representations are statements of past or existing facts. Notwithstanding these semantic distinctions, representations and warranties are more often than not used interchangeably in the acquisition context. Representations and warranties serve a number of purposes in the acquisition process. The seller's representations and warranties create a picture of the business being acquired. The representations and warranties of each party allow the other party the right to terminate the acquisition before closing if such representations and warranties are discovered to be false. The representations and warranties of each party may also provide a basis upon which the other party may recover damages if such representations and warranties prove to be false.

Generally, a covenant represents an agreement to do something or to desist from doing something in the future. Covenants serve a variety of functions in the acquisition process. Some covenants are to be performed prior to closing and serve as steps that must be taken by the applicable party before the transaction may close (e.g., the parties may need to covenant to obtain Hart-Scott-Rodino Act clearance). Relatedly, covenants typically include the obligation of each party to take the steps necessary to fulfill the conditions to closing. Covenants usually describe how the target corporation is to be run prior to closing. Other covenants relate to post-closing obligations and rights of the parties. The failure to fulfill a covenant by a party may result in liability of that party for breach of contract.

Conditions refer to a state of facts on a future date, sometimes not within either party's control, the existence or nonexistence of which excuses one or both of the parties' obligation to close. Stated differently, after the acquisition contract is signed, a party is obligated to consummate the transaction unless one or more of the conditions to the party's obligation to close have not been fulfilled. The conditions serve as a checklist for the parties in ascertaining what needs to happen for the transaction to close.

Many acquisition agreements include indemnification provisions, giving a party the right to be indemnified by another party for certain damages and losses incurred by the indemnified party as a result of breaches of the other party's representations, warranties or covenants.

While each of the parts of the acquisition agreement discussed above is different, they are interrelated and designed to work together. For example, a seller may represent and warrant that certain material contractual consents are necessary to the assignment of such contracts in the proposed transaction. The seller would covenant to obtain (or use its best efforts to obtain) the required consents. A condition of the buyer's obligation to close would be the receipt of such consents. If the seller failed to disclose contractual consents that it was required to disclose, and the buyer was damaged as a result of such nondisclosure, the seller might have to indemnify the buyer for such damage. The above concepts are discussed in more detail below.

The Seller's Representations and Warranties

The seller's representations and warranties are generally much more extensive than the buyer's, but this is not always the case. For example, if the seller is accepting stock as a large part of the acquisition consideration, the seller may require the buyer to provide more extensive representations and warranties to give the seller comfort regarding the proposed investment in the buyer.

In an asset acquisition, the principal representations and warranties are usually made by the seller himself, frequently joined in by principal stockholders if the seller is closely held. In a stock acquisition, representations and warranties are made by the selling stockholders.

Representations and warranties are substantially the same for stock and asset acquisitions. Some of the more important areas that should be covered by the seller's representations and warranties are discussed below.

1. Financial Statements

Prior to entering into a contract for sale, the buyer will have obtained from the seller financial statements, which should contain a current balance sheet and income statements covering the results of the seller's operations for the period ending on the date of the current balance sheet and for several prior periods. Generally, the buyer will try to secure the seller's warranty that the financial statements fairly, completely and accurately present the seller's financial position, assets and liabilities as of the dates of the statements and the results of operations for the period or periods covered by the statements. This warranty is one of the more important warranties that the buyer will obtain from the seller. It should be included in the contract of sale, unless the buyer is prepared to purchase the seller's business without relying on the financial statements of the seller or if the buyer has satisfied himself by other means that his expectations as to the financial condition and results of operations of the seller's business are justified.

There are various accepted accounting procedures, and the result shown on a financial statement may vary depending upon which procedure is used. For this reason, in addition to obtaining a representation with respect to the current financial statements of the seller, and to avoid subsequent disputes on the extent of the representations, most buyers will also obtain additional specific representations concerning some of the more important items on the balance sheet (e.g., receivables, inventory, taxes and liabilities).

2. Contracts

The buyer will usually succeed to the rights of the seller under the seller's outstanding contracts and will assume the obligations of the seller under the contracts that are assigned to it under the contract of sale. In an asset acquisition, the buyer usually obtains from the seller a representation that each contract listed on the schedule is assignable without the consent of any third party or, if such consent is required, the seller will covenant that he will use his best efforts to obtain consent. The buyer will usually condition his obligations to close on the obtaining of such consents. The warranty provision (in both the stock and asset sale contexts) with respect to contracts usually sets forth those types of contracts that are significant to the seller's business (long-term contracts, contracts requiring the expenditure of more than a specified amount, license agreements, labor contracts) followed by the seller's representation that he is not a party to any such described contracts except for those specifically identified on a schedule to the contract of sale, that such scheduled contracts are enforceable in accordance with their terms, and that none of the parties to any such contracts are in default.

3. Liabilities and Taxes

Most acquisition agreements contain specific representations regarding liabilities and taxes of the seller, even though the financial statement warranty covers much of the same ground. The purpose of these representations is to provide an extra degree of comfort in two troublesome areas. The representation concerning liabilities usually states in substance that, except to the extent reflected, reserved against or given effect in the latest balance sheet or as set forth in a schedule, the seller had no liabilities of any nature as of the date of the balance sheet, whether absolute, accrued, contingent or otherwise, and that, since the date of the latest balance sheet, the seller has incurred no liabilities other than in the ordinary course of business and consistent with past practice. Additionally, the seller will usually be asked to warrant that, as of the balance sheet date, all taxes have been paid or provided for in the balance sheet. Under that warranty, the seller will be responsible for any tax deficiencies that may subsequently be assessed against him or his operations. Typically, the seller will also be asked to make various other representations concerning taxes and the tax status of the seller.

4. Corporate and Stock Matters

This category embraces a variety of representations and warranties relating to the corporate organization and capitalization of the seller and his subsidiaries, good title to shares, and the taking of requisite corporate action. The seller or his stockholders are invariably asked to represent that the seller is a corporation duly organized, validly existing and in good standing under the laws of the state of incorporation with the corporate power and authority to carry on his business as presently conducted. Similar representations are sought regarding subsidiaries of the seller.

In any transaction involving the sale of stock, the seller is usually asked to make certain representations concerning capitalization. This includes a declaration as to the number of shares of stock of different classes authorized or presently outstanding, a statement to the effect that the stock was validly issued and a warranty that at closing the purchaser will acquire good and valid title to all of the seller's shares, free and clear of all liens, options, proxies, charges or encumbrances of any nature.

5. Additional Representations and Warranties; Disclosure Schedules

The representations discussed above are not intended to cover all of the areas for which the buyer might properly seek protection through the representations and warranties of the seller. For instance, a representation to the effect that the seller's principals have no knowledge of any facts or circumstances that will adversely affect the business, earnings or properties of the seller may also be regarded as useful by the buyer. However, this warranty should never be used as a substitute for an independent examination of the seller's business by the buyer. Generally, the areas to be covered by the seller's warranties are suggested by the nature of the business conducted by the seller and the types of assets being sold.

The typical means by which the buyer formally obtains data from the seller is through the use of schedules or lists, sometimes referred to as "disclosure schedules." Generally, the disclosure schedules are used to reflect exceptions to representations and warranties or to provide additional data with respect to a representation that could otherwise clutter up the acquisition agreement.

From the seller's viewpoint, the main question surrounding the disclosure schedules is the amount of detail required. While there is no definitive answer in this regard, the prudent approach is to provide enough information so that the buyer either receives the requisite data in the schedule or is referred to documents that will give him that information with neither misleading statements nor omissions. Completion of the disclosure schedules can be a time-consuming, difficult task for the seller. However, the seller's early focus and attention to the disclosure schedules can help prevent unnecessary liabilities following closing.

The Seller's Covenants

The seller's covenants are affirmative and negative. The seller's negative covenants are designed to restrain the seller from operating the business during the period from contract signing to closing in a manner that might adversely affect the business, properties or goodwill of the business being acquired. In addition to restraining the seller's operations, restrictions will be imposed on the seller in issuing dividends, repurchasing stock or materially amending his certificate of incorporation (in a manner effecting a recapitalization). The extent of the restrictions will depend on the length of the period during which the conduct of business will be subject to restraints. It might not be unreasonable to impose tight restrictions on the seller's business operations when an early closing is contemplated. In the alternative, if a closing date is projected that is more than four or five months in the future, the seller will need greater flexibility and freedom of operation if he is to maintain his competitive position through the closing without having to seek the buyer's consent to various transactions.

In addition to his negative covenants, the seller will usually be asked to covenant affirmatively that he will use his best efforts to preserve his staff, business and organization intact; that he will permit access by the buyer and his representatives to his books and premises; and that he will obtain (or use his best efforts to obtain) the necessary consents to assignment of his contracts and leases that require consents. The seller may also be required to file all tax returns required to be filed for operations up to the closing date, and the buyer may require that all such taxes be paid by the seller.

If the sale is one of assets, the seller will usually be required to change his name. If the sale involves a sale of stock, covenants concerning resignations of officers and directors and other steps to facilitate the changeover of management or the restructuring of the corporation may be required.

The Buyer's Representations, Warranties and Covenants

Generally, the buyer's representations and warranties are related to its power and authority to consummate the transaction contemplated under the contract of sale. However, if the purchase price is to be deferred, payable in installments or payable in securities of the buyer, the buyer will usually be required to make broader representations and warranties more closely resembling those given by the seller, including representations and warranties concerning or relating to his financial condition, his future operations and the securities that are to be issued to the seller. The buyer will usually be asked to covenant that any trade secrets and similar materials that he may obtain from the seller during or by reason of the acquisition negotiations be kept confidential and that any writings with respect to such information be returned to the seller if the sale is not consummated.

Indemnification

Many contracts of sale include a provision for indemnification. Generally, the provision for indemnification gives a party the right to be indemnified by another party for certain damages and losses incurred by the indemnified party as a result of the other party's breach of representations, warranties or covenants. However, indemnification rights and obligations will vary substantially depending on the type of transaction involved, the business terms of the transaction, the specific risks involved, the parties' respective negotiating leverage and numerous other factors.

The seller usually has a far greater risk of a claim for indemnification being made against him because the seller typically makes much more extensive representations and warranties. The indemnification obligations of the buyer will often mirror those of the seller, but the risk of a claim being made against the buyer thereunder is far less.

The seller will often seek to limit the time within which the buyer may make a claim against him under the seller's indemnity. The seller may also seek to circumscribe his liability under the indemnity by, among other things, requesting a dollar limitation or ceiling on his indemnification obligations, thresholds or deductibles that must be met or exceeded before a claim for indemnification may be asserted, that the indemnity be the buyer's exclusive remedy in connection with the acquisition agreement, that the source of payment of any indemnification obligation be limited to a particular fund and a variety of other devices designed to limit his liability under the indemnity. Whether the seller will be successful in negotiating such limitations depends upon the seller's bargaining power and other factors.

It is not uncommon for a buyer to seek a specific indemnity from the seller with respect to a particular risk. For example, if the seller is a manufacturer, the buyer may insist on a separate indemnity relating to environmental liabilities and may further require that those obligations not be subject to any ceiling, threshold or other limitation agreed to with respect to the general indemnification provisions. The buyer may also request a separate indemnity with respect to taxes, liabilities relating to the seller's employees or any other matter.

The mechanics of handling claims asserted by third parties against the buyer for which the seller is or may be liable may also be set out in the indemnification provision. In this regard, the parties may decide to impose upon the buyer the obligation to notify the seller of any claims in excess of a stated minimum amount and to give the seller the opportunity to conduct the defense of such third parties' claims.

The buyer often requests that a portion of the purchase price be placed in escrow. This approach provides the buyer with a readily available fund from which he can satisfy any claim that he might have against the seller or the indemnitors under his or their indemnity, or it can be used to ensure the availability of funds to satisfy only certain liabilities of the seller, such as those arising out of a tax audit. The necessity of an escrow fund varies depending on whether the purchase price is payable in a lump sum or by installment obligations. If the purchase price is payable in installments over a period of time, the buyer may be able to offset his claims against any unpaid installment. In this instance, an escrow will not be needed unless the installment obligations are evidenced by negotiable notes or the amount and frequency of installments are such that the buyer feels that the amounts deferred or the duration of their deferral is insufficient to afford protection. Similarly, when the purchase price is payable in securities that are not transferable for a period of time, there is probably less necessity for an escrow arrangement than if the purchase price were payable in cash. The amount of cash or securities that may be placed in escrow depends on the buyer's estimate of the potential liability of the indemnitors, their financial responsibility, their availability and the amount of cash they will want in hand, including any cash they will need to pay taxes in connection with the sale.

Chapter 10

Operations Prior to Closing and the Closing

This chapter discusses the events surrounding the closing of the transaction. The closing emerges as a critical aspect of the transaction because the sale is actually consummated at that time. The operation of the business prior to closing, fulfillment of closing conditions, and investigation and due diligence will be considered.

Operations Prior to Closing

The contract of sale is typically structured around three critical dates. The first is the date of the most current financial statements furnished by the seller, sometimes referred to as the "balance sheet date." The significance of this date lies in the fact that many of the warranties that the seller is asked to make, particularly those relating to items on the balance sheet, are made as of this date. These warranties have to be updated to the "contract signing date," the second critical date, and the seller will also warrant that during the interim period between the balance sheet date and the contract signing date, no materially adverse changes occurred in the business, assets or prospects. The third critical date is the "closing date," on which the sale is actually consummated and the business of the seller passes into the hands of the buyer. It is on this date that the conditions to the obligations of the respective parties to consummate the acquisition must be satisfied. Since even after the contract signing date the seller will retain control over the conduct of the business, it is necessary to set forth in the contract the guidelines for the operation of the business through the closing date. These are covered by covenants under which the seller agrees that he will operate the business only in the ordinary course, that he will not borrow money, change his capitalization, or the like, without the consent of the buyer, and that he will preserve for the benefit of the buyer the assets and goodwill of the business being sold.

The covenants that restrict the operation of the business during the transitional period between the contract signing and the closing date may result in a loss of certain business opportunities during this period. For this reason, it may be desirable to provide for a simultaneous contract signing and closing, particularly if the transaction is not complicated and the buyer can sufficiently evaluate the business prior to the closing. Such a procedure eliminates interim reviews and certificates concerning the status of the business between contract signing and closing. Although the contract obligations of the parties may be fixed as of the contract signing date, if the closing is deferred, there are often means available by which a disillusioned party may thwart or even avoid the binding obligations of such an agreement prior to transfer. Unfortunately, many acquisitions require certain action to be taken subsequent to contract signing and before closing. As a result, a simultaneous signing and closing is often not possible.

Conditions to Be Fulfilled by the Seller

The buyer's obligations to close are usually conditioned on the seller's warranties being true and correct at the closing, on the seller's due and faithful performance of his covenants and on the absence of any material adverse change in the seller's business between contract signing and closing. Usually, as a separate condition, the seller will be required to deliver to the buyer at closing a certificate warranting as of the closing date that the seller has complied with all of the foregoing conditions.

Other conditions to the buyer's obligations to close might be the following: execution of employment agreements with key employees; securing of necessary consents to the assignment of contracts and leases in the case of an asset transaction; obtaining approval of the transaction by the seller's stockholders, or, when the consideration for the acquisition is the buyer's stock, an effective registration statement under the 1933 Act and the listing on a national exchange covering securities of the buyer to be issued at the closing. If the consent or issuance of a license or certificate by a governmental body is required for the buyer to conduct the seller's business, the obtaining of that consent, license or certificate should also be a condition to the buyer's obligation to close. Although licenses and consents are more often required in asset acquisitions when new corporate entities seek to enter regulated businesses, they may also be required in stock acquisitions when there are changes in the stock ownership of business subject to governmental control.

The delivery of an opinion letter from the seller's counsel is also a usual condition of closing. Counsel's opinion will generally deal with the organization, good standing and capitalization of the seller, his power and authority to consummate the sale of his business and such other matters as the enforceability of the seller's contracts, outstanding litigation, liens and encumbrances on the seller's assets and the like. Such an opinion is not a guaranty of these matters; rather, it is used to supplement the warranties of the seller.

Another condition often required in larger acquisitions is the use of a limited last-minute review of the seller's financial books and records by either the seller's accountants or the buyer's accountants. After this review, the accountants will deliver to the buyer a "cold comfort letter." Generally, this letter states that, on the basis of this limited review, nothing has come to the attention of the accountants that would indicate that any material adverse change in the operations of the seller's business has occurred since the date of its last financial statement.

A party may always waive a condition to his obligations to close. In effect, then, if the seller fails to satisfy a condition to be fulfilled by him, the buyer has the option to close or not to close. The failure of the seller to satisfy such a condition will not, however, give the buyer the right to damages unless the satisfaction of the condition is also covered by a warranty or covenant of the seller.

Conditions to Be Fulfilled by the Buyer

Some of the conditions to the seller's obligations under the contract of sale may mirror the buyer's obligations. For example, both the buyer and the seller may be required to deliver and execute certain employment contracts or obtain a favorable tax ruling or tax opinion letter.

Investigation and Due Diligence

The buyer will undoubtedly want to make a thorough review of the business and operations of the seller prior to signing a contract for sale. A comprehensive checklist is essential to a buyer's investigation of the seller's business. Although the type and coverage of the checklist will vary with the transaction, in every precontract investigation there are necessarily three areas of review and analysis—legal, financial and business. Obviously, there will be some overlap, and it should be noted that the term "precontract investigation" might well be a misnomer. Many of the matters usually included in this term are, in fact, investigated not only before the contract is executed but also during the period between contract signing and closing. If time does not permit the complete investigation of all pertinent matters prior to contract signing, this is generally accomplished before closing, with appropriate warranties in the contract. The nature and extent of the investigative duties of the seller and the buyer in a particular transaction are necessarily dependent upon a number of factors, including the characteristics of the seller's business, the relative size and status of the seller and the buyer, and the nature of the transaction.

Chapter 11

Estate Planning Considerations

One of the biggest mistakes a seller or buyer of a business can make is to fail to take into account the estate planning consequences of the transaction. Relatively few sellers are aware that a sale of a business often creates a golden and sometimes once-in-a-lifetime opportunity to save a significant amount of estate and gift tax. Even fewer buyers are aware that the purchase of a business can create a similar or even greater opportunity to save estate and gift tax. For the seller, the tax benefit typically will be immediate and almost certain, whereas for the buyer the tax benefit will usually be prospective and less certain. To achieve maximum tax savings, it is essential that a seller begin planning in the early stages of the sale process, preferably before an investment banker has been retained, because the value of the business will increase as the sale becomes more likely. Early planning is also important to a buyer, but less so because the purchase price will not change as the transaction ripens.

In addition to the tax saving opportunities, the sale or purchase of a business can involve gift and estate tax pitfalls with potentially catastrophic tax results, which could have a major impact on an individual's basic estate plan. Accordingly, an experienced estate planning attorney should be consulted by the seller and the buyer in the early stages of every sale and purchase of a business.

This chapter describes some of the strategies and techniques available to sellers and buyers to take advantage of the estate and gift tax saving opportunities created by the sale or purchase of a business. Some of the relevant planning considerations for both sellers and buyers will also be identified. In addition, this chapter will briefly address some of the gift and estate tax pitfalls of which sellers and buyers should be aware, as well as some of the ways in which a basic estate plan can be affected by the sale or purchase of a business.

Gift and Estate Tax Rules

Before addressing the estate and gift tax saving opportunities of the sale or purchase of a business, it may be helpful to review the basic federal estate and gift tax rules.

1. Estate Tax

For most high-net-worth individuals, the federal estate tax will be the largest tax that they or their family will ever pay. The federal estate tax is imposed at death on the transfer of an individual's taxable estate. The taxable estate generally includes all assets owned by an individual at death and is determined by taking into account unlimited marital and charitable deductions for transfers to a spouse or charity. In addition, there are a variety of credits against the estate tax, the most significant of which is the unified credit (equivalent to an estate tax exemption). In the case of married persons, the unused federal estate tax exemption of the first spouse to die may be transferred to the surviving spouse, in which case the survivor's estate and gift tax exemptions will be increased by the unused amount. Lifetime gifts that use the gift tax exemption reduce the estate tax exemption dollar for dollar. The federal estate tax rate is 40% and the federal estate tax exemption is $5,250,000 (indexed for inflation) for 2013 and thereafter.

2. Gift Tax

The federal gift tax is imposed on the total amount of taxable gifts made by an individual in a calendar year. Generally, a gift is any transfer for less than full consideration. Taxable gifts are determined by taking into account unlimited marital and charitable deductions for transfers to a spouse or charity. There is a gift tax annual exclusion, under which, as of 2013, the first $14,000 of gifts in a calendar year by the same donor to the same donee (or in certain trusts) will not be considered gifts. In addition, there is a unified credit against the gift tax, which is equivalent to a $5,250,000 lifetime gift tax exemption. Gifts that use the lifetime gift tax exemption reduce the estate tax exemption dollar for dollar. The federal gift tax rate is 40% for gifts in 2013 and thereafter. A husband and wife can elect to treat a gift made by either of them to a third party as if the gift had been made one-half by each of them. The annual exclusion and gift tax exemption are indexed for inflation.

3. GST Tax

The federal generation-skipping transfer (GST) tax aims to prevent avoidance of the estate and gift taxes by means of transfers to or in trust for persons who are two or more generations younger than the transferor (referred to as "skip persons"). Generally, the federal GST tax is imposed on the amount of a transfer to a skip person. A transfer can be direct (such as a gift by a grandparent to a grandchild) or indirect (such as a trust created by a parent for a child that is distributed to a grandchild upon the child's death). Transfers to or in trust for skip persons are sheltered by the GST exemption. In the case of a trust, the GST exemption is allocated to the trust. The GST tax rate is 40% and the GST exemption is $5,250,000 (indexed for inflation) for transfers in 2013 and thereafter.

4. State Taxes

State estate, inheritance, gift and GST taxes vary from state to state. Many states have an estate tax, but only Minnesota and Connecticut have a gift tax (although several states subject deathbed gifts to estate or inheritance tax). Illinois, New York and New Jersey, to name a few, have an estate tax with an exemption that is significantly lower than the federal estate tax exemption. The estate tax exemption in Illinois is $4,000,000 in 2013. The estate tax exemptions in New York and New Jersey in 2013 are $1,000,000 and $675,000, respectively. A majority of states, including Florida and Nevada, do not have a state estate or inheritance tax. Some states, such as Iowa, have only an inheritance tax. New Jersey has both an estate and an inheritance tax. To complicate matters, an individual's estate may be subject to estate or inheritance tax in multiple states. The important planning point is that an estate that is exempt from federal estate tax may still incur a state estate or inheritance tax.

The Seller's Perspective

Probably the easiest way to save estate and gift tax is to transfer an asset to children or other family members when the value of that asset is relatively low by comparison to its possible future value. By doing so, the future increase in value will not be taxed. This principle enables the seller of a business to save estate and gift tax if the seller acts early enough in the sale process.

1. Business Valuation

When a business is sold, the takeover price will usually be significantly greater than the value of the stock in the early stages of the sale process. Unlike publicly traded stock, stock of a closely held business is not readily marketable. For this reason, the fair market value of closely held stock generally is determined by taking into account a discount for lack of marketability. The discount can be significant and often is in the range of 20% to 40%. In addition, if a transfer of a block of stock in a closely held business represents a minority interest or if the stock is nonvoting, the stock will be valued by taking into account a minority-interest discount. This discount reflects the fact that the holder has no power to compel distributions, liquidation or a sale of the business, or to control the management of the business. Minority-interest discounts of 10% to 20% are common. Generally, a business appraiser determines the discounts. However, when a business is sold, the price paid by the buyer typically will not take into account any discounts. Since the buyer will be purchasing all of the stock or assets of the business, these discounts are not warranted.

From an estate planning standpoint, the trick is to transfer stock to family members when its value is relatively low in comparison to the possible takeover price so that the increase in value will avoid estate and gift tax. Generally, this means transferring the stock as early in the sale process as possible. For valuation purposes, the sale process is a continuum. Early on, the value of the stock will be at its lowest point (and the lack of marketability and minority-interest discounts will be at their highest). As subsequent events occur that make the deal more likely, the value of the stock will begin to increase until, at some point, when the deal becomes a virtual certainty, the discounts will be almost nonexistent and the stock value will be nearly the same as the takeover price.

The seller of a business can use a variety of techniques to transfer stock to family members at a value that is lower than the takeover price. These techniques range from simple gifts that use the gift tax annual exclusion, to gifts that use the $5,250,000 lifetime gift tax exemption, to more sophisticated techniques, such as GRATs and installment sales to grantor trusts.

2. Outright Gift

The simplest (but often not the best) way to transfer stock to other family members is to make a direct gift, either outright or in trust. The gift can be structured to use the $14,000 gift tax annual exclusion. To the extent that the gift exceeds the annual exclusion, it will use the business owner's $5,250,000 lifetime gift tax exemption. Generally, gifts should not be made in excess of this exemption because such gifts will result in gift tax liability.

> **Example 1**: Bob owns all the stock of Growth Co. Recently, a business appraiser determined that the aggregate value of Bob's stock on a nonmarketable, minority-interest basis was $20,000,000. Bob believes that, in a takeover, the business will sell for around $30,000,000. Bob intends to hire an investment banker to explore the possibility of selling the business. Before doing so, Bob makes a gift of stock valued at $5,278,000 to his two children. $28,000 of the gift is sheltered by the gift tax annual exclusion ($14,000 per child). The balance of the gift, $5,250,000, uses Bob's entire $5,250,000 lifetime gift tax exemption (and reduces his estate tax exemption from $5,250,000 to zero). After the gift is completed, Bob starts the sale process, and the business is sold six months later for

$30,000,000 (a 50% premium over the nonmarketable, minority-interest value). Upon the sale, Bob's children receive $7,917,000 ($5,278,000 × 150%). As a result, $2,639,000 of appreciation, the $28,000 sheltered by the annual exclusion and all future income and growth with respect to the sale proceeds received by Bob's children will avoid estate tax upon Bob's death. The federal estate tax savings will be at least $1,055,600. In addition, the gift will save state estate or inheritance tax if Bob resides in a state that has such a tax.

3. GRAT

Although the estate tax savings in Example 1 are significant, Bob can achieve even greater estate tax savings by using more sophisticated techniques. Perhaps the best alternative in terms of balancing risk and reward is a grantor retained annuity trust (GRAT). In very simple terms, a GRAT is a trust that can avoid estate tax on a significant portion of the future total return (income and/or appreciation) of an asset at a zero or nominal gift tax cost.

Example 2: Assume the same facts as in Example 1, except Bob wants to achieve even greater estate tax savings and decides to transfer shares to a GRAT. Before doing so, Bob recapitalizes Growth Co. with two classes of common stock, voting and nonvoting. Bob transfers 50% of the stock of Growth Co., represented by nonvoting shares, to a GRAT with a two-year term. The shares have a discounted value of $10,000,000. The GRAT will make a payment of $5,090,094 to Bob at the end of each year during the term, for a total of $10,180,188. Under applicable IRS actuarial tables (assuming a 1.2% interest rate), the payments have a present value upon creation of the GRAT of $10,000,000. Therefore, the value of the gift is zero. If Growth Co. is sold six months later for $30,000,000, the GRAT will receive $15,000,000, which it can use to make the two payments to Bob ($10,180,188 total), leaving it with $4,819,812. Further, because the trust is a grantor trust for federal income tax purposes, the capital gain tax on the sale will be paid by Bob, thereby providing the GRAT with an additional benefit. At the end of the two-year term, the remaining net proceeds ($4,819,812) plus all future income and growth on this amount will pass to Bob's children free of gift and estate tax. The federal estate tax savings will be at least $1,927,924.80. In addition, the GRAT will save state estate or inheritance tax if Bob resides in a state that has such a tax.

Importantly, the GRAT has no downside and little gift tax risk. If the IRS increases the value of the nonvoting shares put in the GRAT, no gift tax will be due because the payments to Bob will simply self-adjust based on the adjusted value of the shares. Further, if the company is not sold, the GRAT will continue to own nonvoting shares, which can be used to make the two payments to Bob. Bob will own the voting shares and therefore will continue to control the company. In addition, because the value of the gift to the GRAT is zero, Bob will not use any of his $5,250,000 lifetime gift tax exemption and can instead use that exemption to make other gifts.

In addition to offering the advantages described in Example 2, a GRAT is a surprisingly flexible vehicle in terms of timing and performance. A variety of strategies can be used to enhance or lock in the performance of a GRAT or to pull assets out of an underperforming GRAT in order to create a new GRAT. For instance, if the sale in Example 2 progresses to the point that a deal seems likely but is not yet certain, the value of the shares of Growth Co. likely will increase significantly, perhaps to $25,000,000. In such case, if Bob wants to make sure that the GRAT will perform even if the deal later falls through (in which case the value of the shares will drop to $20,000,000), he can buy the shares back from the GRAT in exchange for an installment note at a purchase price equal to the higher value. The GRAT can then pay the annuity by canceling part of the note at the end of each year.

4. Installment Sale to Grantor Trust

Although a GRAT will often be the best technique for transferring stock of a business that is going to be sold, a variety of other techniques are available in appropriate circumstances. A particularly attractive strategy is to use a sale to a grantor trust.

> **Example 3**: Assume the same facts as in Example 2, except Bob previously made a gift of $2,000,000 to a GST Trust for his children that will avoid estate tax for all future generations. Instead of transferring $10,000,000 of nonvoting shares of Growth Co. to a GRAT, Bob sells the shares to the GST Trust in exchange for an installment note that provides for the annual payment of interest at .95%, with a balloon principal payment at the end of nine years. If Growth Co. is sold six months after the sale to the GST Trust for $30,000,000, the trust will receive $15,000,000. If the trust pays off the note ($10,000,000 principal balance and accrued interest after six months of $47,500), it will have $4,952,000 of net sale proceeds. Further, because the trust is a grantor trust for federal income tax purposes, no transaction between Bob and the trust will have any income tax consequences, and the capital gain tax upon the sale will be paid by Bob, thereby providing the trust with an additional benefit. The net proceeds of $4,952,000 and all future income and growth with respect to the sale proceeds received by the GST Trust will avoid estate tax for all future generations. The federal estate tax savings will be at least $1,981,000. In addition, the installment sale will save state estate or inheritance tax if Bob resides in a state that has such a tax.

As Example 3 shows, a sale to a grantor trust can produce a better economic result than a GRAT. Furthermore, such a trust can be designed to avoid estate tax for all future generations. This can also be done for a GRAT, but only to the extent of the GST exemption. The principal drawback of a sale to a grantor trust is that it involves far more risk than a GRAT, especially if the sale to the trust occurs shortly before the sale of the business. For instance, if in Example 3 the IRS revalues the nonvoting shares sold to the trust at $14,000,000, a $4,000,000 gift will result (if the IRS wins). This gift will use Bob's remaining lifetime gift tax exemption and result in a federal gift tax liability of $300,000. In addition, this gift may cause part of the trust to be subject to estate or GST tax in the future. By comparison, a GRAT has no gift tax risk because the payments to Bob are expressed as a percentage of the value of the nonvoting stock as finally determined for federal gift tax purposes. Accordingly, if the IRS is successful in increasing the value of the nonvoting shares from $10,000,000 to $14,000,000, the payments to Bob will simply increase proportionally, and the value of the gift will continue to be zero. A sale to a grantor trust also is vulnerable to attack under sections 2036 and 2702 of the Code. If successful, IRS challenges under these sections could result in catastrophic estate or gift tax consequences. For this reason, a GRAT will often be the vehicle of choice.

5. Other Considerations

Many questions must be addressed by a seller in the estate planning phase of the sale of a business. How much should the business owner transfer, and how much should he keep? What type of technique should be used? Should the transfer be outright or in trust? If a trust is used, how should it be structured? Should the trust be a grantor trust? Should voting or nonvoting shares be transferred? Will the seller have enough assets to pay his or her own income tax (including any tax attributable to a grantor trust)? In answering these questions, the seller should keep in mind the possibility that the business will not be sold or that it will be sold for a price greater than anticipated. In short, the seller will have a lot to think about and will have relatively little time to do so. Although the process is not an easy one, the potentially enormous estate and gift tax savings more than justify the effort and typically will pay for all of the investment banking, accounting and legal fees of the entire transaction many times over.

The Buyer's Perspective

The seller and buyer in a sale and purchase of a business typically have the same goal. Both of them want to make a profit. The difference between the two is that the seller will already have made a profit and is looking to cash in, whereas the buyer hopes to make a profit in the future. For this reason, it is far easier to develop an appropriate estate planning strategy for a seller than for a buyer.

1. Structuring the Purchase

Although the planning process for a buyer is often more complicated and difficult, the reward can be as great as or greater than it is for a seller. Take Bob from the previous examples, for instance. Had he transferred 50% of the stock of Growth Co. to a GST Trust when Growth Co. was formed, the savings would have been enormous.

> **Example 4**: Bob forms Growth Co. with $1,000,000. Shortly after formation, Bob gives 50% of the stock, represented by nonvoting shares, to a GST Trust for his children that will avoid estate tax for all future generations. Bob's gift is valued at $300,000, taking into account an aggregate 40% discount for lack of marketability and minority interest. The trust is a grantor trust with respect to Bob. After 15 years, Growth Co. is sold for $30,000,000. The GST Trust receives $15,000,000. The capital gains tax upon the sale is paid by Bob, thereby giving the trust an added benefit: $14,700,000 ($15,000,000 less initial gift of $300,000) and all future income and appreciation with respect to the sale proceeds received by the GST Trust will avoid estate tax for all future generations. The federal estate tax savings will be at least $5,880,000. In addition, the gift will save state estate or inheritance tax if Bob resides in a state that has such a tax.

As Example 4 shows, by transferring stock to family members when the value of the business is relatively low in comparison to its expected future value, enormous estate tax savings can be achieved. Of course, businesses can and do go south, in which case a gift that uses a portion of the $5,250,000 lifetime gift tax exemption may waste that portion of the lifetime exemption. Also, if the amount the business owner wants to transfer to family members exceeds his or her gift tax exemption, other techniques must be considered.

In selecting the appropriate strategy for a buyer, a balance must be struck between risk and reward. Selection of the appropriate technique will depend on a variety of factors, including whether the purchase is for cash or will be financed, the ages and financial means of other family members, the likelihood that the business will be profitable, the reasonably expected rate of return, whether the buyer will purchase stock or assets, whether the buyer and other family members will be active in the business and many other factors that often vary from case to case.

If the buyer will be purchasing stock, it will often be preferable to complete the purchase and then transfer stock to other family members. This will enable the buyer to take advantage of lack-of-marketability and minority-interest discounts that will not be available if the stock is initially purchased by other family members or trusts.

> **Example 5**: Bob sells all of the stock of Growth Co. to Steve for $30,000,000. Steve believes he can grow the company even more, to $50,000,000, in relatively short order. Steve would like to transfer one-third of the stock of Growth Co. to a GST Trust for his three children that will avoid estate tax for multiple generations. Steve has thought about making a gift of $1,000,000 to such a trust, using part of his lifetime gift tax exemption, and then lending $9,000,000 to the trust so that it can purchase $10,000,000 of stock from Bob. Although this seems like a good idea, it is actually a bad idea because the purchase price paid by the trust will not take into account valuation discounts. A better alternative is for Steve to buy all the stock of Growth Co. Steve can then make a gift of $1,000,000 to the GST Trust, which, in turn, can purchase one-third of the stock of Growth Co. from Steve in exchange for an installment note. The purchase price paid by the trust to Steve will be determined by taking into account lack-of-marketability and minority-interest discounts. Assuming an aggregate discount of 40%, the purchase price for one-third of the stock will be only $6,000,000 (rather than $10,000,000). The amount of the installment note will be $6,000,000. By structuring the transaction in this manner, Steve will reduce his estate by $4,000,000. If Growth Co. is later sold for $50,000,000, the GST Trust will receive $16,666,667. After paying the note, the GST Trust will have $11,666,667 ($1,000,000 from the gift and $10,666,667 of net sale proceeds). The net sale proceeds of $10,666,667 and all future income and appreciation with respect to the assets of the GST Trust will avoid estate tax upon Steve's death and for all future generations. The federal estate tax savings will be at least $4,266,667. In addition, the transaction will save state estate or inheritance tax if Steve resides in a state that has such a tax.

2. Breaking Control Premium

Although the result in Example 5 for Steve and his family is a good one, by taking a few simple steps when Growth Co. is acquired, Steve can achieve even greater estate tax savings. After buying two-thirds of the shares of Growth Co. from Bob, Steve will own all of the voting shares, as well as some nonvoting shares. Because he will have voting control, upon his death his voting and nonvoting shares will be valued without taking into account a minority-interest discount. Even worse, there will be little, if any, lack-of-marketability discount. Thus, if Steve dies when Growth Co. has a takeover value of $50,000,000, two-thirds of that value, $33,333,333, will be subject to estate tax upon his death. In effect, all of Steve's shares will be valued at a control premium.

Steve can easily break the control premium by transferring enough voting shares to his wife and/or children (or trusts for their benefit) so that he has less than 50% of the voting shares. For example, Steve could give 3% of the voting shares to his wife and 16% of the voting shares to each of his three children, leaving him with 49% of the voting shares. As a practical matter, Steve will continue to be in control as long as his wife or at least one of his children agree with him. With proper planning, Steve can transfer voting shares to his wife and children by means of a relatively nominal gift. If Steve follows this plan, the value of his two-thirds interest in Growth Co. upon his death will be determined by taking into account full lack-of-marketability and minority-interest discounts. Assuming an aggregate discount of 40%, the amount subject to estate tax upon Steve's death will be only $20,000,000 (rather than $33,333,333), producing federal estate tax savings of at least $5,333,333. In addition, this plan will save state estate or inheritance tax if Steve resides in a state that has such a tax.

3. Other Opportunities

As previously noted, planning for a buyer of a business is far more complicated than planning for a seller of a business, and the selection of the best strategy will depend on a variety of factors. In some cases, a GRAT or an installment sale to a grantor trust will make sense even if there is no prospect for selling the business. For example, if the buyer of a business believes that the business will produce a high total rate of return, both a GRAT and a sale to a grantor trust will make sense. If a business will be acquired largely with debt but will have more than sufficient cash flow to service the debt, it may make sense to structure the transaction so that the initial purchase is made by an entity, such as a limited liability company, in which the buyer's children or trusts for their benefit have significant interests. As the business grows and the debt is paid down, the increase in value will inure to the children and trusts to the extent of their percentage interests, thereby avoiding estate tax upon the buyer's death. In some cases, it may make sense to use preferred equity interests in a limited liability company or partnership.

Gift and Estate Tax Pitfalls

Most estate planning attorneys view the sale or purchase of a business as an estate planning opportunity for the seller or the buyer. However, sellers and buyers should be aware that they can run into a number of pitfalls in attempting to take advantage of this opportunity.

An entire chapter of the Internal Revenue Code, chapter 14, creates one tax trap after another for unwary business owners. The provisions of chapter 14 are arcane and can result in catastrophic and unexpected gift and estate tax consequences. Chapter 14 must be taken into account if interests in a business are or some day may be owned by two or more family members. Although chapter 14 is more likely to be a problem if the business is operated in the form of a limited liability company or partnership, it also can be a problem if the business is conducted in corporate form. A number of provisions that are commonly found in limited liability company and partnership agreements entered into by unrelated parties can create problems under chapter 14. Accordingly, it is essential that such agreements be drafted or reviewed by an experienced estate planning attorney.

A variety of other pitfalls can be encountered, depending on the circumstances. In some cases, these will not be apparent until the process of selling or purchasing the business is well under way. Accordingly, it is essential that an experienced estate planning attorney be involved in every stage of the process, particularly if GRATs or other techniques have been implemented early on.

Impact on Basic Estate Plan

Virtually every sale or purchase of a business will dramatically change the business owner's personal and financial situation. As a result, changes to the business owner's basic estate plan may be necessary. For example, the seller of a business who owns a significant amount of life insurance may find that he or she no longer needs insurance or needs less insurance. In addition, a variety of provisions in basic wills and revocable living trusts may no longer make sense after the business has been sold. One example is a provision that relates to the holding, disposition and management of the business. Another example is a provision that gives the business to a child who previously was active in the business, with other assets passing to other children. Conversely, the buyer of a business may want to put special provisions or provisions relating to the business in his or her will or revocable living trust.

A number of other estate planning changes may be appropriate. A seller who has made a profit and cashed in may wish to make substantial gifts to charities, either during his or her lifetime or upon death. Alternatively, a seller may wish to establish a private foundation. By making charitable gifts in the year of the sale, the seller can achieve income tax savings. As an aside, it should be noted that a variety of techniques can be used to save income tax before the business is sold. However, the use of such techniques often creates business or tax issues that many business owners view as not being worth the effort.

Because it is difficult to generalize as to the changes that should be made to an estate plan, every seller or purchaser of a business should have his or her estate plan reviewed by experienced estate planning counsel at the time of the transaction. In some cases, it may be necessary to completely revise the business owner's basic estate planning documents.

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