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Structuring a Transaction: Ways to Minimize Income Tax Implications for Sellers

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Published Date: Mar 1, 2019

Whether you're buying or selling a business, you need to negotiate more than just price. How the deal is structured can have a significant impact on the amount of income taxes that will be paid by both parties.

Most taxable sale transactions are typically structured in one of three ways: asset sale, stock sale, or stock sale with a Sec. 338(h)(10) election. Each of these structures provides certain advantages to the buyer or seller. Below we'll discuss the nuances of each structure and the importance of the allocation of the sales price.

Asset Sale

In an asset sale, the seller remains the legal owner of the business entity, while the buyer acquires negotiated assets, such as equipment, inventory, customer lists, and goodwill. Typically, asset sales do not include the seller's cash or long-term debt.

Buyers generally prefer an asset sale because of the ability to control their liability exposure and create potential income tax savings. With an asset sale, the buyer will set up a new entity to acquire the assets of the seller. Therefore, the buyer is not assuming any of the potential liabilities that would follow the entity—such as tax, litigation, and contract liabilities—unless they are specifically assumed by the buyer under the sales agreement. In addition, the buyer records the acquired assets at the agreed-upon sales price (generally fair market value) rather than the seller's depreciated basis. This gives the buyer a stepped-up basis for depreciation purposes and thus provides them with additional current and future-year income tax savings.

For a seller, an asset sale can put them at a tax disadvantage. If the target business is an S corporation, partnership, or LLC taxed as a partnership, any business assets they've depreciated or amortized are now subject to depreciation recapture if sold at a gain. In other words, when the value of an asset exceeds its depreciated/amortized tax basis, the difference is recaptured and taxed not at the most favorable 20% capital gain rate, but, instead, at higher ordinary income tax rates and/or the higher 25% capital gain rate.

On the other hand, if the target business is a C corporation, the sellers will be subject to "double taxation," as the business is taxed on gains from the sale and then shareholders are taxed again on any proceeds they receive from the corporation upon its liquidation.

Because buyers typically prefer an asset sale, this structure can have a positive impact on sales price for the seller. When depreciation and amortization can be used to reduce income taxes, the buyer's annual cash flow increases. Because the buyer is gaining these tax benefits, the seller could anticipate a higher price under an asset sale versus a stock sale. However, the seller may still end up with less cash in their pocket after they pay the tax on the asset sale.

Stock Sale

In a stock sale, the buyer purchases the business equity (i.e., shares of stock or partnership/membership interest). Because this exchange occurs between the buyer and the business owners, the entity itself does not recognize any taxable gains. Therefore, depreciation recapture can be avoided (with exceptions if the target entity is a partnership or LLC taxed as a partnership). In addition, in the case of a C corporation target, the imposition of the "double tax" is avoided.

In a straight stock sale, the buyer takes on all liabilities of the selling company at the time of sale. This may include liabilities where the exact amounts are not known at the time of sale or those that are not even recorded on the financial statements. In addition, the buyer in a stock sale does not receive the stepped-up tax basis in the acquired assets and, therefore, forfeits the additional depreciation/amortization expense and the resulting income tax savings that could be achieved with an asset sale.

In terms of income taxes, sellers typically benefit from a stock sale. While a stock sale may decrease the price a buyer may be willing to pay, it can increase the seller's net proceeds by reducing their tax obligation.

Stock Sale with Sec. 338(h)(10) Election

A stock sale with a Sec. 338(h)(10) election is a combination of a stock sale and an asset sale. In this structure, the buyer acquires the business equity for legal purposes, but the transaction is treated as an asset sale for income tax purposes. Under this "deemed" asset sale, the target entity is deemed to have sold all its assets and then liquidated, distributing the proceeds to its owners.

A stock sale is often required when the target has certain assets that are difficult or even impossible to transfer. The buyer doesn't have to retitle individual assets—as they would have to under an asset sale—and can generally assume non-assignable licenses and permits. Thus, even though a buyer would prefer the tax benefits of an asset sale, they may be forced to utilize a stock sale.

If a Sec. 338(h)(10) election is made, the buyer (which must be a C or S corporation) can still obtain a stepped-up tax basis in the target's assets. This means the buyer gets the same cash-flow benefits from the increased depreciation/amortization an asset sale would have provided. Why would a seller be willing to agree to a Sec. 338(h)(10) election? As previously discussed, a seller will generally not want an asset sale because of the higher income taxes that would likely result. Since the election must be made by both the buyer and the seller, there must be some benefit to the seller. To understand the potential benefit, we need to first look at the types of target entities that are allowed to make a Sec. 338(h)(10) election:

1. A corporation that is a subsidiary in a group that files a consolidated return. This requires the subsidiary's stock be owned at least 80% by other members of the group.
2. A corporation that is a subsidiary in a group that is *eligible* to file a consolidated return but chooses not to.
3. An S corporation.

By limiting the eligible types of targets in a Sec. 338(h)(10) transaction to the three types of corporations listed above, the rules ensure that the deemed liquidation of the target entity will not result in a second taxable transaction. This is accomplished by the following:

1. When a corporate subsidiary liquidates into a parent that owns 80% of the subsidiary's stock, the subsidiary recognizes no gain or loss on the distribution of all of its assets to its parent corporation.
2. This same rule applies when a corporate subsidiary liquidates into its corporate parent—provided the parent owns 80% of the subsidiary's stock—even if no consolidated return is filed.
3. When an S corporation target recognizes gain on the deemed asset sale, that gain increases the stock basis of its shareholders. On the deemed liquidation, the shareholders must recognize gain or loss on the difference between the FMV of the assets distributed and the shareholders' basis in the stock. Because that basis has been increased by the asset sale gain, the gain will not be recognized a second time upon liquidation.

In each of these situations, the seller will have only one level of tax, not two. However, the tax that is paid may be higher than would have been paid in a pure stock sale. Therefore, if a buyer is looking for a Sec. 338(h)(10) election, the seller should be able to negotiate a higher sales price to take into account their higher tax liability.

Allocation Matters

In a transaction structured as a taxable asset sale, or if a Sec. 338(h)(10) election is made, the sales price must be allocated to the acquired assets and liabilities, with the residual value allocated to goodwill. How the price is allocated matters, but what's good for the buyer is not good for the seller. That is why the sales price allocation needs to be part of the negotiation process.

In an asset sale, buyers would prefer to allocate the sales price to assets that depreciate or amortize quickly (such as equipment) versus goodwill (which amortizes over 15 years) or real estate (which depreciates over 27.5 or 39 years). Allocating sales price to assets that can be depreciated/amortized more quickly provides the buyer with an accelerated depreciation schedule and generates tax savings.

On the other side, sellers can be subject to ordinary income tax rates or the 25% capital gain tax rate when higher amounts are allocated to assets that have been previously depreciated or amortized. For sellers, there's an advantage in having more of the sales price allocated to assets that don't have any previous depreciation or amortization, such as goodwill.

In other pertinent negotiations, deferring the collection of the sales price out over several years could drop the seller into lower tax brackets, providing greater after-tax proceeds as the sales price is collected over time.

Tax implications can have a big impact on sale negotiations. Buyers and sellers should both have experienced M&A tax accountants on their transaction team to create an optimal deal structure that produces the desired outcome—without taxing surprises.

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