Tax Considerations Regarding the Sale or Merger of a Company

Companies are most often acquired to improve economic efficiency, extend opportunities for the acquirer, or to affect the transfer of wealth to the seller, and these acquisitions may take various forms including a merger, asset sale, partial or total equity sale, or stock for stock exchange. The structure and type of transaction can greatly affect the amount of after-tax wealth a sale can provide, as well as the amount of consideration paid. Since the amount of gain from the sale of a company can often be considerable, it is obviously imperative to delay or avoid as much taxation as possible. One needs to understand the tax implications of selling a company, but it is imperative that a business owner also consult a qualified tax advisor to determine the tax ramifications of a proposed transaction, based on his/her particular circumstances.

On most occasions, the seller will realize a profit equal to the amount the consideration (stock, cash, or assets) exceeds the seller's basis (amount paid for the stock or assets, net of depreciation or dividends). For example, if an owner invested $2 million to start a company and sold the company for $10 million, the basis is $2 million and the gain is $8 million. These rules can be more complex for owners of an S corporation, because the basis in the equity can be decreased by disbursements or losses, or increased by capital contributions and income of the company.

Income from an S corporation is generally taxed at an individual's tax rate, and the gain realized from the sale of an S corporation is generally considered capital gain. The level of taxation depends upon the duration that the asset (i.e. capital equipment, equity, etc.) was held; assets held for less than 12 months are taxed at the short-term rate equal to the individual's ordinary income tax rate (which may be as high as 35%), while the long-term tax rate (assets held over one year, also called capital gains tax) is 15% if an individual is in the 25%-35% tax bracket. If depreciation is recaptured, the amount of gain due to depreciation is taxed at ordinary income. Additionally, gain from assets that are considered "collectibles", such as jewelry or artwork, may be subject to a different tax rate. The gain from a sale may also be subject to state and local tax, which may be as high as 10%, depending on the municipality. However, these state and local taxes may be deductible items for purposes of computing federal income. Last, if regulatory requirements are met, a transaction can qualify as a re-organization, and only a portion (or none) of the gain would be realized at closing. This type of transaction generally requires a substantial amount of the consideration to be paid in equity, where the owner's basis is transferred to the tendered stock.

In summary, the structure of a transaction can result in significant tax savings or an increase in the consideration paid. It is imperative that a business owner consult a qualified tax advisor to determine the tax ramifications of a proposed transaction, based on his/her particular circumstances.

Stock-for-Stock Exchanges

A transaction where the consideration paid for the acquired company consists of stock is relatively common and can result in the deferral of taxes due on the gain of the sale. The minimum amount of consideration to be paid in stock may range from 50-100%, depending on the type of transaction. However, these transactions have two basic requirements:

Continuity of Interest This means simply that the stock of the acquirer is substituted for the stock of the target

Continuity of Business Interest The acquirer must continue to use the assets of the target firm in a productive manner.

A successful stock-for-stock transaction will generally result in the seller receiving stock in the acquiring firm, where the seller takes a "substituted" basis in the acquirer's stock. Essentially, this means that the seller takes a basis in the acquirer's equity equal to the basis the seller had in their own equity, plus any taxable gain received from the transaction. Consequently, in a tax-free transaction, the majority of the taxes owed are deferred until the equity in the acquirer is sold. In some circumstances, there may be permanent tax avoidance if the stock is not sold until death. In this case, the basis in the equity will be "stepped-up", or permanently increased, equal to the market value assigned at the estate tax valuation.

Sale of Assets

There are generally two ways for a seller to transact an asset sale: the acquirer can purchase all of the shares of the target, or the acquirer may purchase the equity of the seller and a 338(h)(10) election is jointly made by the buyer and seller. In either case, the transaction is taxed as if the assets are purchased, and the gain realized is the difference between the consideration paid and the depreciated value of the assets. It is also possible to transact a stock-for-asset sale that qualifies as a tax-free exchange. This would require at least 90% of the fair market value of the net assets (net of liabilities) and at least 70% of the fair market value of the target's gross assets to be exchanged for voting stock of the acquiring firm.

Asset purchases are often desirable for the acquiring company, because the acquirer can step-up the basis of the purchased assets to market value, and recognize a basis in certain acquired intangible assets (i.e. patents). The acquirer may then depreciate these assets, resulting in a lower tax obligation in the future. Additionally, assets sales allow the company to only acquire the desired assets. Because of these potential advantages, an acquirer may be willing to pay a premium for this deal structure. However, assets sales are generally undesirable if the target company is a C corporation, because the transaction is taxed at the corporate level, and then taxed *again* when the proceeds are distributed to shareholders. These effects may be mitigated if the company has net operating losses (NOLs) or capital loss carry forwards (CLCFs) that can be carried forward to the date of the transaction.

The second level of taxation in the asset sale of a C Corporation can be deferred or avoided by retaining the assets purchased. The proceeds of the sale would not be distributed to shareholders, but invested in marketable securities or property. The company must remain in existence, and the equity in the company will receive a stepped-up basis at the death of the shareholder. The stock may then be liquidated without any further income tax to the shareholder. The company will, however, recognize a gain on any distribution or dividend, and some earnings must be distributed to avoid a penalty tax associated with personal holding companies. However, some benefit is still realized, because C corporations generally qualify for the dividend received deduction, where 70% or greater of the dividend is not taxed. The alternative minimum tax may be applied in some cases, and a tax professional should be consulted to determine whether the Alternative Minimum Tax (AMT) will apply.

In the sale of an S Corporation, it often makes sense to structure the transaction as an asset sale, so that the acquiring company can achieve a step-up of the target company's assets. Acquirers are often willing to pay a premium for this type of transaction, because the tax benefit the acquirer receives may exceed the premium paid for the transaction. From a tax perspective, if the company is organized as an S corporation, a sole proprietorship, or as a limited-liability partnership (LLP), the company is a conduit entity where there is only one level of taxation incurred on the gain, equal to the amount the consideration paid exceeds the company's basis in the assets. Owners or partners in a conduit entity should consider structuring a transaction as an asset sale if the after-tax profit of the asset sale exceeds the after-tax profit achieved through a stock sale.

Installment Method of Gain Recognition

An installment sale is a transaction structured so that one or more payments are made later, generally in a later tax year. In such a case, the gain is recognized in each year proportionally to the payment received in that year. However, it is possible to incur an interest charge if the deferred portion exceeds a statutory amount (currently $5 million). For further reading, reference Internal Revenue Code §453A(b)(2)(B).

In summary, a stock-for-stock transaction allows the owner to defer a possible tax obligation, but does not provide the liquidity or diversification of a taxable deal, since the consideration will largely be paid in the stock of the acquirer. A taxable transaction allows an owner to receive cash consideration immediately, allowing for greater liquidity and flexibility, but may obligate the owner to a substantial tax obligation in that year. If a taxable transaction is selected, the structure of the transaction may allow the owner to negotiate a greater premium for his/her company, but the tax consequence of each structure should be examined in order to determine which will provide the greatest after-tax profit. It is imperative to consult a tax professional to examine the effect of these principles for your individual situation.

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