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SEARCH PARTNERS

The Search Fund Guide to Sales & Acquisitions

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Preface

This guide contains certain tax considerations to keep in mind when buying or selling a business and is meant as a general introduction. The issues mentioned are a sampling of the various tax considerations that will arise in a given transaction. This discussion does not address all of the areas of concerns during negotiations, as there are often other issues that may be deal specific. Additionally, this guide does not address the effects of state income taxes which may significantly differ from federal income tax treatment. It is highly advisable to obtain tax advice from a qualified professional when buying or selling a business.

Asset vs Stock Transactions

Buyers and sellers of a business are confronted with many important issues during negotiations. One of the first issues to confront is:

Should the transaction be structured as an asset sale/purchase or a stock sale/purchase?

The simpler structure is the sale of the target company's stock to a buyer. The mechanics of such a transaction are simpler than those of a sale of the assets of a corporation. A stock sale generally refers to a corporate target although it can be either an S Corporation or C Corporation. If the corporation owns non-assignable assets, such as leases, service contracts or royalty agreements, a sale of stock may be the most feasible method of selling a business.

An alternative to a stock sale is a sale of the company's assets. In an asset sale, the purchaser only acquires specified assets of a business (which may or may not be substantially all business assets) and specific liabilities, generally ongoing liabilities of the business (accounts payable, accrued expenses) and not general debt of the seller. As will be discussed later, elections under Internal Revenue Code ("IRC") §336(e) or §338(h)(10) may allow the transaction to be treated as an asset sale rather than a stock sale for tax purposes.

Which method is preferable?

Buyers will generally prefer an asset purchase due to the increased tax depreciation and amortization deductions resulting from the acquisition. The increased deductions occur because the assets are purchased at their fair market value, allowing the purchaser to recover their purchase price in the form of depreciation or amortization deductions over the depreciable or amortizable lives of the assets[1].

Sellers including search funds will generally prefer a stock sale in order to avoid double taxation (for owners of a C Corporation) and receive more preferable long term capital gains tax treatment on the sale of the stock. Double taxation occurs when a C corporation sells its assets. The gain from sale is taxed first at the corporate level at ordinary income tax rates, and then taxed a second time when the proceeds are distributed to its stockholders in the form of dividends[2]. On the sale of an S Corporation a seller may receive increased benefits by selling stock vs assets due to the long term capital gain treatment of the stock being sold.

The next page shows a comparison of the advantages and disadvantages for both the seller and buyer in both asset and stock transactions.

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[1] I.R.C. §1016

[2] I.R.C. §316

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Asset vs. Stock Transaction Comparison

Asset Sale/Purchase

Purchaser

Advantages

1. The Purchaser can choose the assets it wants to acquire.
2. Generally not liable for any of the Target Company's liabilities (other than those specifically assumed).
3. The Purchaser may benefit from additional depreciation and amortization tax deductions.

Disadvantages

1. Can be expensive, complex & time consuming, title to all assets must be transferred.
2. The Purchaser may be required to pay state and local sales/bulk taxes on the asset sale.
3. Consents and assignments from third parties may be required.
4. Purchaser does not receive Seller's tax attributes (Net Operating Loss carryovers etc).
5. Assignment of patents and trademarks may be difficult.

Seller

Advantages

1. Seller can continue operation of Target and maintains tax attributes of Target.
2. Generally the consideration paid is in cash or cash equivalents.

Disadvantages

1. Can be expensive complex & time consuming, title to all assets must be transferred.
2. Consents and assignments from third parties may be required.
3. Seller remains responsible for liabilities that are not assumed by buyer.
4. Seller may incur a "double tax" on the transaction (C Corporations).
5. A portion of the tax paid by the Seller can be at higher ordinary tax rates**
6. Stockholders residing in low or no income tax states may be at a disadvantage agreeing to an asset sale over a stock sale.

Stock Sale/Purchase

Seller

Advantages

1. Simplicity and speed - No transfers of title to assets required.
2. Preferential capital gains treatment on the sale.
3. Seller is generally not liable for the liabilities of the Target.
4. No double taxation. (C corporations).
5. Third party consents may not be required.

Disadvantages

1. Generally less cash consideration involved than an asset sale.*
2. Seller does not retain tax attributes of Target. (Net Operating Loss carryovers etc)

Purchaser

Advantages

1. Simplicity and speed - no transfers of title to assets required.
2. Generally, no state and local sales taxes or bulk taxes.
3. Purchaser may retain tax attributes of Target. (Net Operating Loss carryovers etc)

Disadvantages

1. Generally all liabilities of the Target assumed, including contingent and unknown liabilities.
2. No "stepped up" basis on the acquired assets.
3. Purchaser cannot pick and choose the assets to be acquired.

* In many instances a buyer may be willing to increase the purchase price in order to receive asset sale treatment and benefit from the immediate tax benefits from the additional tax depreciation/amortization.

** If the target company has significant assets that have been partially or fully depreciated, a portion of the gain may be subject to ordinary income recapture.

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Practical Example - Asset vs Stock Transaction

A, a search fund which owns target company ABC (C corporation) is seeking to sell the business.

P intends to acquire ABC.

Additional facts:

- Fair market value of ABC's assets = $1,000,000
  - Fair market value of the fixed assets = $600,000
  - Goodwill = $400,000
- ABC's tax basis in its assets = $400,000
- A's basis in the ABC stock = $400,000

Assume corporate level gain will be taxed at a combined 40% federal and state tax rate.

Assume shareholder - level gain will be taxed at a combined 28.8% federal and state tax rate.(20% federal long term capital gains rate + 3.8% net investment income tax[3] + 5% assumed state tax rate)

Results from asset sale

- ABC company recognizes $600,000 of gain taxed at 40% on the sale of its assets, resulting in corporate level tax of $240,000.
- If ABC liquidates and distributes the after-tax cash of $760,000 to A, A will recognize a $360,000 gain on liquidation and an additional tax of $103,000 at a blended federal and state rate of 28.8%.
- A's after-tax cash received is $657,000 ($1,000,000 – $240,000 – $103,000).
- P receives a stepped-up basis of $1,000,000 in ABC company's assets received, which it will then depreciate or amortize over the respective useful lives of the assets acquired.

Note: *As a result of the asset sale, the goodwill valued at $400,000 will be amortized over 15 years.*

Results from stock sale

- ABC recognizes no gain or loss.
- A recognizes $600,000 of gain ($1,000,000 purchase price less $400,000 stock basis).
- A pays $173,000 of federal and state tax, ultimately netting $827,000 of after-tax cash. (28.8% tax rate x $600,000 of gain =$173,000 of A's capital gains tax)
- ABC's tax basis in its assets remains unchanged, and it continues depreciation of the assets in the same manner as the previous owner.
- ABC company's net operating losses carry over (if any), but may be limited (under §382 and the SRLY rules).

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[3] Assuming the net investment income tax is applicable in this example.

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§338(h)(10) Election – Deemed Asset Sale

What is a §338(h)(10) election?

A §338(h)(10) election allows the buyer that acquires the stock of a target corporation to treat the transaction for tax purposes as if it was a purchase of the corporation's assets, although still a stock transaction for legal purposes[4] . For a stock transfer to be treated for tax purposes as an asset sale, the buyer and the seller must **both** make the election[5].

Who may claim the election?

This election is only available if both parties are corporations (C or S) and at least 80% of the stock of the target corporation is acquired[6].

What types of target corporations are eligible?

- A corporation that is a subsidiary in a consolidated group;
- A corporation that is a subsidiary in a group that is eligible to file a consolidated return; or
- An S-Corporation[7]

What are the benefits?

The §338(h)(10) election allows the target corporation to sell the stock for legal purposes, therefore keeping alive any contracts, but for tax purposes allows the buyer to enjoy the more attractive depreciation deductions related to the increase in basis to the fair market value of the acquired assets.

Note: The purchaser may be willing to increase its purchase price if it they are able to reap the additional tax benefits from an asset sale. Additionally, if the target company has pre-existing net operating losses which it can use to absorb gains from the assets sale it may be more open to making the election.

Can S Corporations make the §338(h)(10) election?

An S corporation can make a §338(h)(10) election to step up the basis in a C corporation target's assets. The deemed asset sale is reported on the old target C corporation's final tax return.

Note: *If the S corporation is acquired by a C corporation, the target company's S-election status terminates due to the acquisition of its stock by an ineligible shareholder[8].*

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[4] This only refers to federal income tax treatment. Certain states may not recognize this election.
[5] Treas. Reg. § 1.338(h)(10)-1.
[6] I.R.C. §338(d)(3).
[7] Treas. Reg. § 1.338(h)(10)-1(b).
[8] I.R.C. §1361(b)(1).

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§338(h)(10) Election – Additional Considerations

1. The incremental cost to the seller(s) of making a §338(h)(10) election depends on the difference, if any, between "inside basis" (i.e., The target company's basis in its assets) and "outside basis" (i.e. the seller's basis in the target company's stock)
2. A §338(h)(10) election may also change the character of the gain, to the extent the deemed asset sale results in ordinary income.

Note: Generally, a search fund's acquisition vehicle is an LLC and not a corporate entity therefore, a §336(e) election (discussed later) may be more applicable.

Many target companies do not have significant fixed assets and the biggest asset being 'stepped up' to its fair market value in the transaction is goodwill. Below is an example of the §338(h)(10) election involving mainly goodwill:

Assumptions:

A. 35% tax rate
B. The entire basis step up is allocable to goodwill
C. Target's inside basis in assets = $50
D. Seller's outside basis in target stock= $100
E. Purchase price = $500
F. Target company has no liabilities
G. Target company is an S corporation since inception

Results:

- Gain recognized by on stock sale= $400 ($500-$100)
- Gain recognized by on asset sale= $450 (i.e. $50 of additional gain resulting from §338(h)(10) election)
- Additional tax to = 35% x $50 gain = $17.5
- Additional benefit to purchaser= 35% x $450 = $157.5/15 years = $10.5 tax savings each year

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336(e) election – An Alternative to the §338(h)(10) election

Unlike a §338(h)(10) election, a §336(e) election is available when a target is acquired by non-corporate purchasers, i.e. partnership, LLC, etc. A §336(e) election leads to results similar to those obtained in a §338(h)(10) election. Under §336(e), if a corporate seller or S corporation shareholder disposes of stock of a target corporation in a qualified stock disposition ('QSD'), an election may be made to treat the transaction as a sale of the target corporation's assets. Below is a summary of the §336(e) election requirements:

- Seller is a domestic corporation that makes a qualified stock disposition of stock of another corporation;
- A disposition of stock includes a sale, exchange or distribution. Tax-free and related party transactions are excluded;
- The target corporation must be a domestic corporation (including S corporations)[9];
- A QSD is a transaction or series of transactions in which stock of the target corporation representing 80 percent of the vote and value is sold, exchanged or distributed (or any combination) during a 12-month period[10].The "12-month period" is defined as the 12-month period beginning with the date of the first sale, exchange, or distribution of stock included in a QSD[11]. Therefore, the 12 month period can span over 2 tax years.
- The purchaser can be one or more persons and/or entities (and is not restricted to corporations as is the case with §338(h)(10))[12]. This makes it easier to accommodate multiple buyers who have different profiles and want different end structures;
- The election is made by **both** the seller and the target corporation[13].

Legally owning the stock of an entity while receiving the step-up to fair market value and the ability to depreciate and amortize the acquired assets would very beneficial for a search fund group. Upon the search fund's exit from the business, there will be multiple options on how to exit depending on the buyer. The flexibility of this approach makes an election under 336(e) attractive where possible. Below is a comparison between the §338(h)(10) and §336(e) elections:

338(h)(10) Election	336(e) Election
Seller must be a member of a consolidated group or shareholders of an S-corporation.	Seller(s) may be any domestic corporation that makes a qualified stock disposition ('QSD') or shareholders of an S-corporation that make a QSD. Generally, all members of a consolidated group that dispose of Target stock are treated as a single seller.
Purchaser must be a single corporation.	Purchaser is not required to be a corporation and multiple purchasers are allowed.
Applies to a purchase of at least 80 percent of Target stock.	Applies to any combination of sales, exchanges, or distributions equaling at least 80 percent of Target stock.
Seller and Target must be a domestic entity.	Seller and Target must be a domestic entity.
Election jointly made by purchaser and seller. In the case of an S-corporation Target, all S-corporation shareholders (not just those disposing of their Target stock) must agree to make the election.	Election jointly made by seller and Target. In the case of an S-corporation Target, all S-corporation shareholders (not just those disposing of their Target stock) must agree to make the election.

[9] Treas. Reg. § 1.336-1(b)(1).
[10] Treas. Reg. § 1.336-1(b)(6).
[11] Treas. Reg. § 1.336-1(b)(7).
[12] Treas. Reg. § 1.336-1(a)(2).
[13] Treas. Reg. § 1.336-2(h).

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Drop-Down of Assets or Stock to an LLC

What if a §338(h)(10) or §336(e) election is not a viable option?

An asset 'drop-down' to an LLC is another possible option to be considered. An asset 'drop-down' to an LLC consists of the following:

- The target company (a corporation) contributes its assets to a newly formed wholly owned member LLC[14]. The LLC would also assume any liabilities intended to be transferred to the purchaser as part of the transaction.
- On the closing date, the target company would sell a partial or whole interest of the LLC to the purchaser.
- The transfer will often be done before the purchase agreement is signed, so it is clear to both parties which assets are being sold.

Result:

1. The target company is treated as selling the underlying assets, and the purchaser is treated as purchasing the underlying assets.
2. The target company (the parent corporation) can then either liquidate or remain in existence.
3. Gain recognition on any retained LLC interest is deferred.
4. The LLC obtains a step up in the basis of its assets to the extent of purchaser's proportionate share of assets[15].

Note: The LLC is treated as a "disregarded entity," and all its assets are treated as if they were directly owned by the target company[16].

Is there an alternative if the assets are difficult to transfer?

If the assets are difficult to transfer, the same tax result as above can be accomplished by performing an S corporation "inversion" transaction. This transaction is performed in the following steps

1. The target company creates a new wholly owned S corporation* - NEWCO;
2. The target company contributes their target stock to the new S corporation (on a tax-deferred basis)[17];
3. The target company then elects to be treated as a subsidiary of NEWCO;
4. The target company subsequently converts to an LLC and the purchaser buys and interest in the newly formed LLC.

*The owners of the new NEWCO must be the individual owners of the target company's stock. S corporations have strict limitations on who may own S corporation stock. The following entity types cannot own S corporation stock: partnerships, LLC's and C & S corporations[18].

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[14] I.R.C. §721.
[15] I.R.C. §743(b)
[16] Treas. Reg. § 301.7701-2(c)(2)(i) .
[17] I.R.C. §351
[18] I.R.C. §1361(b)(1)

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Drop-Down of Assets or Stock to an LLC- Continued

What are the benefits of the 'LLC Drop-Down' structure?

- This structure is often utilized in instances where the seller(s) will retain an interest in the business in excess of 20%. This allows the seller to continue on as a partial owner and maintain the risks and rewards of ownership.
- The drop-down structure is beneficial where the owner's entity is operated through an S corporation and the buyer is an ineligible shareholder. The original S corporation may continue post-transaction as an equity owner in the LLC.
- The LLC drop-down structure allows the parties to take advantage of the often favorable pass-through tax treatment afforded LLC owners.
- Additionally, the 'LLC Drop-Down' structure allows sellers to sell less than 100% of the assets if they choose.
- Many transactions involve intangible assets; therefore it's important for search fund groups to be aware of the extensive anti-churning rules. These rules were enacted to prevent taxpayers from transferring previously non-amortizable intangible assets, such as goodwill to related parties in order to take advantage of the newly available 15-year amortization.

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Sale of Personal Goodwill

What is personal goodwill?
The IRS describes goodwill as the excess of net earnings over and above a fair return on the net tangible assets[19]. Personal goodwill exists when an individual's reputation, expertise, or contacts contribute significantly to a company's value and future income stream. Whereas corporate goodwill (or "enterprise goodwill") is derived from characteristics specific to a particular business, regardless of who owns or operates it. Whether or not personal goodwill is present depends **significantly** on facts and circumstances.

What are the benefits?
Establishing personal goodwill is a method to partially avoid double taxation within a C-Corporation on an asset sale followed by a corporate liquidation. Reducing this double taxation is to separate the intangible assets personally owned by the shareholders, personal goodwill, from those owned by the corporation.

By separating the assets, the gain from the sale of assets can be divided between the corporation and the shareholders. By dividing the gain between assets owned by the corporation and assets owned by the shareholders, one level of tax can be avoided on the sale of the assets owned by the shareholders. This reduces the amount of gain realized at the corporate level, therefore reducing the total tax liability upon liquidating the corporation. Any gain on the sale of assets owned personally by the shareholders incurs only **one** level of tax at preferential individual capital gains tax rates.

Note: *Selling shareholdings may use allocations to personal goodwill as a way to allocate the purchase price disproportionately with share ownership to reflect contributions to the business.*

How do you establish personal goodwill?
In order substantiate the existence of personal goodwill it is imperative to establish the following:

- The target company should be a small, closely held corporation;
- There should be 2 separate sales agreements:
    1. Between the shareholder and buyer (personal goodwill)
        a) an agreement between the buyer and sellers on the proper allocation of goodwill
    2. Between the corporation and the buyer (corporation's assets and goodwill, if any);
- No existing non-compete clause or employment agreement between the seller and the corporation – prior to sale;
- No evidence of transfer of personal goodwill to the corporation - prior to the sale ;
- Subsequent to sale - a non-compete agreement should be signed between the buyer and seller (the agreement should be in effect for several years);
- Selling shareholder should notify their clients of the sale;
- Selling shareholder is known and recognized in the business community;
- Customers and suppliers deal directly with the selling shareholder;
- The target corporation is dependent upon the selling shareholder's skills, talents, and personal relationships;
- An independent appraisal of assets and goodwill must be performed;

Note*:* *From the buyer's perspective, they are indifferent to whether the goodwill is treated as personal or corporate. Regardless of treatment they will amortize the acquired goodwill over a 15 year period.*

Whether personal goodwill is appropriate is highly fact specific. It is important to note that proper planning and documentation exist when allocating to personal goodwill, as these transactions may face additional scrutiny from the taxing authorities .

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[19] Treas. Reg. § 1.197-2(b)(1).

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Practical Example – Sale of Personal Goodwill

Facts

A, the sole shareholder of the target company, a C corporation, and is looking to sell the business.

A establishes the existence of personal goodwill

Additional facts of target company:

- Fair market value ('FMV') of all of target company's assets = $1,000,000
  - Fair market value of the target company's fixed assets = $600,000
  - Goodwill = $400,000
- Target company's tax basis of its assets = $400,000
- A's basis in target company's stock = $400,000

Assume corporate level gain will be taxed at a combined 40% federal and state tax rate.

Assume shareholder-level gain will be taxed at a combined 25%** federal and state tax rate.

Asset sale <u>without</u> personal goodwill

- Target company recognizes $600,000 of gain taxed at 40% on the sale of its assets, resulting in corporate level taxes of $240,000.
- If the target company liquidates and distributes the after-tax cash of $760,000 to A, A will recognize a $360,000 gain on liquidation and an additional tax of $103,000 at a blended federal and state rate of 28.8%.
- A's after-tax cash received is therefore $657,000 ($1,000,000 – $240,000 – $103,000).

Asset sale <u>with</u> personal goodwill

- Target company recognizes $600,000 of gain taxed at 40% on the sale of its assets ($600,000 fixed asset FMV – $400,000 Target's tax basis), resulting in corporate level taxes of $80,000.
- If the target company liquidates and distributes the after-tax (corporate) cash of $520,000 to A, A will recognize a $120,000 gain on liquidation and an additional tax of $35,000 at a blended federal and state rate of 28.8%.
- Additionally, the $400,000 allocated to personal goodwill* is taxes at the shareholder level blended federal and state rate of 25%**. Total tax related to the personal goodwill is $100,000.
- A's after-tax cash received is therefore $785,000 ($1,000,000 – $80,000 – $35,000 – $100,000).

Result: The personal goodwill treatment results in a savings of $113,000 for the shareholder A ($770,000-$657,000).

Note: **It is typically assumed personal goodwill has no tax basis due to the nature of how it arises (self-created).*

***It is assumed for this example the personal goodwill is not subject to the 3.8% net investment income tax.*

§1202 – Qualified Small Business Stock Exclusion

§1202 allows holders of Qualified Small Business Stock ('QSBS') to exclude 50% to 100% of capital gains on the sale of QSBS, provided the stock meets all of the following criteria:

1. Issued by a domestic C corporation with no more than $50 million of gross assets at the time of and immediately after issuance[20];
2. Issued by a corporation that uses at least 80% of its assets (by value) in an active trade or business, other than in certain personal services and types of businesses[21];
3. Issued after Aug. 10, 1993;
4. Held by a non-corporate taxpayer;
5. Acquired by the taxpayer on original issuance; and
6. Held for more than 5 years[22].

The percentage of gain on the sale of QSBS excluded from federal income tax is determined as follows:

- QSBS issued from August 11, 1993 – February 17, 2009 = **50%** gain exclusion;
- QSBS issued from February 18, 2009 – September 27, 2010 = **75%** gain exclusion;
- QSBS issued from September 28, 2010 – Present = **100%** gain exclusion[23].

The amount of gain eligible for exclusion is limited to the greater of $10 million or 10 times the taxpayer's basis in the QSBS.[24] Prior to 2013, the maximum long term capital gains rate ("LTCG") rate was 15% and the effective tax rate on §1202 gains was 14%, giving taxpayers little incentive to claim the §1202 exclusion. In 2013, LTCG rates increased to a maximum 23.8% and brought the benefits of §1202 into the spotlight.

With limited exceptions, a stockholder can elect to "rollover" gain from the sale of QSBS. In a rollover a stockholder can sell the QSBS without currently paying tax on the gain if it (A) held the QSBS sold for more than 6 months and (B) buys, within 60 days of the sale, other QSBS (replacement stock). The rollover enables a stockholder to exit an investment in the QSBS while deferring a portion or all of tax on the gain[25].

For additional information on §1202 see:
http://www.eisneramper.com/qsbs-exclusion-0216.aspx

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[20] I.R.C. §1202(d).
[21] I.R.C. §1202(c).
[22] I.R.C. §1202(b)(2).
[23] I.R.C. §1202(a)(2)-(4).
[24] I.R.C. §1202(b)(1)(A).
[25] I.R.C. §1045.

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