**Buy-Sell Agreements (and other slides in Segment 5B)**

Objectives of this arrangement:
1) Preserve the limited ownership group.
2) Fix value/binding price required during lifetime; is a right of first refusal acceptable?
3) Possibly fix value for estate tax purposes.
4) Liquidity for the selling shareholder - assurance that his successors are not in a minority/non-controlling shareholder position after death of that shareholder.
Taxable Corporate Acquisitions/Dispositions

Possible alternatives for the taxable disposition of a corporate business:

1. Sale by the corporation of its assets and the distribution of the proceeds in liquidation.
2. Distribution by the corporation of assets in kind to shareholders who then sell the assets.
3. Sale of the stock by the shareholders.
4. Sale of the assets at the corporate level and no liquidation of the corporation.

Taxable Asset Acquisitions

Sale of its assets by the target corporation to a purchaser for cash, notes, etc. (but not for stock - possible eligibility for tax-free corporate reorganization treatment).

Various types of consideration might be paid for these assets: cash, promissory notes, bonds & other property (e.g., stock of other than the purchaser corporate entity).
Possible structures for the asset acquisition

1) Forward cash merger of Target into Acquirer for cash (or merger into subsidiary of Acquirer). Equivalent to a sale of assets and liquidation by the acquired corporation.
2) Liquidation of the Target followed by the shareholder sale of assets to Acquirer.
3) Sale of assets by Target with subsequent distribution of the proceeds to shareholders.
4) Sale of assets, with the proceeds retained.

Issues Upon Retention of Proceeds & Corporate Status

“Lock-in” effect because of retention of stock until death to enable §1014 basis step-up.
Possible personal holding company status risk – requiring current distributions of income to the shareholders to avoid penalty tax.
Possible conversion of the corporation to S corporation status (but note S Corporation limitations).
Allocation of the Purchase Price for Tax Purposes

§1060 requires an allocation of the purchase price paid for assets acquired for cash.
Cf., William v. McGowan case re sale of separate assets and not the sale of the "business" enterprise as one unit.
Cf., the sale of shares of a corporation.
This fragmentation approach requires a purchase price/tax basis allocation among the various assets acquired by purchaser.

Tax Basis Allocation Planning Objectives

Seller: If a tax rate differential exists, a tax planning objective will be to allocate proceeds to those capital assets producing LTCG; but, no tax rate differential exists for a selling corporation (but consider the possible NOL & capital loss carryover utilization).
Buyer: Wants to allocate the purchase price to inventory and other short lived assets to enable a prompt deduction of these costs.
Approaches to Allocation of the Purchase Price

1. Proportionate methods, based on the relative fair market values of all assets.
2. Residual method - allocation (in order) to: (1) liquid assets, (2) tangible assets, (3) intangible assets and, (4) goodwill (i.e., based on the increasing difficulty of valuation).

§1060 implements the residual method.
Also, an allocation is made to a "covenant not to compete", treated as an acquired asset.

Amortization of Intangibles

§197 - Intangible assets are amortizable over a 15 year period without regard to their actual "useful life".

§197 assets defined: customer lists, patents, know-how, licenses, franchises, etc., including goodwill and going concern value and "covenants not to compete" (even though the period of the non-compete covenant is actually much shorter than 15 years).
Allocation of Price - §1060
Asset Classes

Class 1 assets: Cash & cash equivalents.
Class 2 assets: Marketable securities.
Class 3 assets: Accounts receivable.
Class 4 assets: Inventory.
Class 5 assets: Tangible property.
Class 6 assets: Intangibles (§197).
Class 7 assets: Goodwill & going concern value (also §197 assets).

Agreement for Allocation of the Purchase Price?

1) Should the buyer and seller agree on a purchase price allocation?

2) What is the binding nature of such a price allocation agreement on the IRS?

3) Can the taxpayer reject the agreement and report another allocation? See the Danielson case (p. 362 & 365).

§1060 specifies the binding nature of this agreement for the taxpayers.
Stock Acquisitions

Purchaser buys stock of a corporation from the shareholders. Structuring options are:

1. Direct purchase from the shareholders. Similarity to a “B” tax-free reorganization.

2. Reverse Δ cash merger: Purchaser (1) forms a transitory subsidiary which merges into Target and (2) Target shareholders receive cash (and notes) of purchaser. Similar to “Reverse Triangular Merger.”

Stock Acquisitions - Income Tax Results

Results of a direct stock purchase or a reverse subsidiary cash merger:

1. Selling shareholders - capital gain treatment upon sale of their shares.

2. The purchaser takes a cost basis for the acquired shares in acquired corporation.

Impact to the Target Corp.? Unaffected, except should this transaction actually be treated as a deemed asset acquisition?
Kimbell-Diamond case

Corporation acquired stock of another corporation with involuntary conversion proceeds. Objective was to acquire assets. Issue re tax basis of the assets acquired by the corporate transferee in the liquidation. Tax basis higher than asset FMV. Was this a tax-free liquidation of wholly owned subsidiary into parent corporation, under §332? No, held: cash asset acquisition.

Code §338 - Elective Asset Purchase Tax Treatment

Can a corporate shareholder get a tax basis step-up for indirectly acquired assets without the liquidation of the acquired corporation? If treated as a liquidation - therefore, gain recognition results as if the appreciated assets had been (i) distributed in kind, and (ii) re-infused into a new corporation (§351). But, the stock basis to the purchasing shareholder disappears.
**Code §338 Objectives**

1. Same federal income tax effects as if:
   (i) a sale by Target corporation of its assets, followed by
   (ii) a corporate liquidation into parent corp.
2. The buyer gets a cost basis in the assets acquired from Target.
3. Tax attributes of the Target disappear (e.g., the e&p account and the holding periods for the various assets).

**Share Purchases and Tax Planning Structural Options**

1. No §338 election and the asset tax bases inside the corporation are unaffected.
2. Not elect §338, but liquidate under §332 - historic asset tax bases move upstream.
3. Elect §338 and treat the stock transaction as a taxable asset acquisition (keeping corp).
4. Elect §338, treat the acquisition as an asset acquisition, and then liquidate the acquired corporation upstream (under §332).
Qualification Requirements for §338 Election

1. Acquisition by the purchasing corporation of an 80% interest in another corporation during a 12 month acquisition period, i.e., a "qualified stock purchase" has occurred.
2. Buyer must make an irrevocable election.
3. Treated as a hypothetical sale for asset fair market values as of the acquisition date.
   Note: The purchasing corporation has the tax payment obligation for recognized gain.

Defining the Sale Price - Deemed Fair Market Value

"Aggregate deemed sale price" (ADSP) - the price allocable to the assets deemed sold. **Target** treated as **selling** assets for the ADSP.

This deemed sale price includes:

1) price of acquired stock (as grossed-up, to approximate the real price if not all stock held by the purchaser); and,

2) the acquired liabilities (Crane case), including income tax incurred in the sale.

Consider similarity to an asset sale/purchase.
Adjusted Grossed-up Basis of Stock Acquired (AGUB)

Tax basis to new Target for the assets deemed acquired by Purchaser:

1. Grossed-up price of P's recently purchased stock (need to gross-up where not all shares have been acquired).
2. P’s actual basis in non-recently purchased stock (more than 12 months holding period).
3. Target liabilities, including tax liabilities resulting from the deemed asset sale.

Allocation of the Adjusted Grossed-up Basis

The objective of determining this basis is to determine the amount to be allocated to the Target’s assets after the deemed purchase.

This tax basis is allocated to the various assets, as specified in the §338(b)(5) income tax regulations, similar to the §1060 approach to allocating purchase price.
**Subsidiary Sale - Possible §338(h)(10) Election**

Acquisition of the stock of a corp. subsidiary.

Parent corporation is the seller of the target subsidiary corp. stock (keeping sub alive).

Possible §338(h)(10) election - Treat the transaction as (1) if it were a sale of T's assets while a member of the seller's consolidated group, and (2) S then liquidated tax-free into Acquiring Parent under §332. Objective: To avoid two corporate level gain tax events.

### Example (a)
**Asset Sale and Liquidation**

T: (1) adopts a plan of complete liquidation, (1.3 mil. assets and 300,000 debt)

(2) sells (at the corporate level) its assets (subject to liabilities) to P for 800x net cash (with corporate level tax on the gain), and,

(3) distributes the after-tax proceeds to the shareholders in proportion to their stockholdings (shareholders A&B have LTCG).
Example (b)
Asset Liquidating Distribution
T (i) adopts plan of liquidation; (ii) transfers all assets (& liabilities) to shareholders; and (iii) shareholders sell the assets to P. Tax effects of the distribution to (i) corporation - determined under §336(a); and (ii) Shareholders - determined under §331. Also, income tax basis effects to P? Tax basis of assets is $1.3 million (allocated per §1060).

Example (c)
Installment Note Distribution
P paid T $200,000 in cash and $600,000 in notes with market rate of interest payable annually and the entire principal is payable in five years. Issues re: (i) the availability of installment sale treatment upon T’s asset sale and (ii) upon T’s distribution of notes. Further, may A and B (C having loss) report their §331(a) gain on the installment method upon the liquidation of Target? §453(h).


Example (d)
Asset Sale & No Liquidation

Target sells all its assets to P.
T does not liquidate but invests the after-tax proceeds in publicly traded securities.
T recognizes $150,000 of ordinary income and $350,000 net LTCG.
Increase to T’s E&P by $325,000 ($500,000 gain less 175,000 taxes).
No distribution of proceeds and §331 tax avoided is at the shareholder level. Risks?

Example (e)
Stock Purchase  §338 Election

P purchases all the stock of T for $800 per share and makes a Code §338 election.
Shareholders recognize capital gain (or loss) on their share sales.
P is eligible to make a §338 election since a “qualified stock purchase” has occurred.
New T treated as a new corporation which purchased all the old T assets on the day after the acquisition date. continued
Example (e), continued

New T’s basis in its acquired assets:
1) $800,000 grossed up basis
2) $300,000 bank loan
3) $175,000 tax paid
Total adjusted grossed-up basis is $1,275,000.
This $1,275,000 is allocable among T’s assets under Code §338(b)(5).
Stock sale & §338 election same as asset sale.

Example (f)
Stock Purchase  No §338

P purchases all the stock of T for cash but does not make the Code §338 election.
T is not deemed to have sold the assets and, therefore, recognizes no current gain or loss.
T's same asset bases and other tax attributes remain as prior to the sale.
A knowledgeable buyer would not pay $1 million for the stock because of the future income tax liability upon T’s asset sales.
Example (g)
Choice of Sales Method?

Method of choice is a purchase of stock without a §338 election.
If (1) Target sells assets and is liquidated, or (2) Target shareholders sell stock and a Code §338 election is made, the transaction generates tax at both the shareholder and the corporation level. Do not make §338 election and pay current tax merely to get a tax basis step-up!

Example (h)
Target With NOL Carryover

If T had a NOL carryover of $600,000: T could shelter the $500,000 of gain on the deemed sale by using the NOL. A §338 election enables new T to take a stepped up basis to fair market value for assets without any income tax cost resulting from the election. Could P otherwise use the NOL? §382 limit?
**Example (i)  
Target as Subsidiary**

Assume T is a wholly owned subsidiary of S, Inc. and S has 200x adjusted basis in T stock.

1) T distributes all of its assets (subject to the liability) to S in complete liquidation.

   Liquidation of T is tax-free to S (under §332) and to T (under §337).

2) S then sells the assets to P. On the sale of assets S recognizes $150,000 ordinary income and $350,000 net LTCG. P has cost basis.

**Example (j)  
Acquisition of Target Stock**

P insists that the transaction must be structured as an acquisition of T stock.

T is the subsidiary of Seller and a member of a consolidated group.

§338(h)(10) permits S and P to jointly elect to treat the transaction as a deemed sale of T's assets in a single transaction, rather than as a sale by S of the T stock.

S recognizes no gain or loss on the stock sale.
Tax Treatment of Acquisition Expenses

Choices:
1) Immediate Deduction
2) Amortization
3) Frozen in buyer’s tax basis until disposition of the asset.
Cf.: Acquirer’s expenses.
Target’s expenses (hostile or friendly?).

Possible Application of INDOPCO Decision

Holding that takeover costs in friendly takeover were nondeductible capital expenses – since future benefit.
Need not be related to a specific asset.
Different treatment for fees to prevent hostile tender offer – only seeking to preserve the entity - until changing (?) to friendly transaction. Staley case.
Tax Policy Issues in Corporate Acquisitions

Should the repeal of the General Utilities doctrine be reversed in the corporate liquidation/takeover context? Does double tax (corporate and shareholder) encourage a “lock-in effect”? Detriment only to closely held businesses? How provide any relief? At shareholder or corporate level?

LBOs – Tax Limitations on Excessive Debt

1) Applicable high yield debt obligations - §163(e)(5).
2) Limit use of NOL attributable to reduce debt leveraging expense
3) Earnings stripping limitation - Code §163(j).
4) Other remedies?