Red Flags of Buying and Selling a Business

State Bar of Michigan Taxation Section:
Fundamentals of Taxation Program
October 12, 2017

Introduction:
Tax risk mitigation process

Target

- Know the target
- Legal entity
- Federal tax treatment
- State tax treatment
- Foreign tax treatment
- Partnership considerations
- History of entity structure
- Elections affecting target

Transaction

- Know the deal
- Legal deal
- Business deal
- Stock vs. asset
- Know the seller
- Consideration
    - Cash
    - Shares
    - Equity Rollover

Types of tax risk

- Don't forget the small stuff
- Federal, state, and foreign income taxes
- State and foreign non-income taxes
- Revenue-related taxes
    - Sales/use
    - Gross receipts
    - VAT
- Real/personal property
- Employment taxes
- Unclaimed property

Tax risk identification

- Due diligence
- Management
- Income and non-income tax filings
- Income tax provision
- Financial statements
- Legal documents
- Offering memo
- Quantify, quantify, quantify

Tax risk mitigation

- Protect your company
- Change the structure
- Purchase price adjustments
- Escrows
- Indemnities

Introduction:
What creates tax risk in a target?

Introduction: What are you buying?

Corporation

Stock of corporation

- Acquiring all historical risks
- Public v. Private
- Reg. section 1.1502-6
- Elections under IRC section 338(h)(10)

S corporation

Stock of S corporation

- Acquiring all historical risks
- C corporation history
- Quality of election and status
- Elections under IRC section 338(h)(10)

P'Ship

Interests in partnership

- Check entity status
- If pass-through, acquiring mostly state/non-income tax risks
- Pay attention to tax treatment of transaction (e.g., Rev. Ruls. 99-5 and 99-6)

DRE

Stock or interests in a disregarded entity

- Depending on the structure of transaction, historical tax liability could carry over
- QSUB fiction
- Potential carryover of corporate liability when sub is checked or merged into DRE

Foreign Branch

Foreign entity treated as a branch in the U.S.

- Carryover of local country tax
- Verify treatment in foreign jurisdiction


Real, Tangible and intangible assets

- Generally limited carry over of historical income tax liabilities
- Sales/use taxes, Property taxes and, in some cases, employment taxes
- Some states impose successor liability for all taxes, including income/franchise taxes, when assets of trade or business are acquired

Introduction: Comparison of Targets

Entity:	Corporation	Partnership	S Corp.	Limited Liability Company (LLC) Treated as:		
				Partnership	Corporation	Disregarded
Taxpayer	Entity	Partner	Shareholder	Member	LLC	Tax Treatment Looks to Owner
Flow-through of Tax Attributes/ Losses	No	Yes	Yes	Yes	No	
Avoid Double Tax Inefficiency	No	Yes	Yes	Yes	No	
Build Basis in Operations	No	Yes	Yes	Yes	No	
Deliver Step-up at Exit	No	Yes	No (338)	Yes	No	
Consolidation Available	Yes	No	No (QSSS)	No	Yes	
Limited Liability	Yes	No	Yes	Yes	Yes	
Flexibility of Income Allocations	Inflexible	Flexible	Inflexible	Flexible	Inflexible	
Type of Owners	Unrestricted	Unrestricted	Restricted	Unrestricted	Unrestricted	

Negotiating the Purchase Agreement: Buyer Tax Objectives

I. Tax step-up

II. Efficient structure for Seller

III. Rollover (tax-deferred or after-tax)

IV. Buyer's structure

   A. Debt
   B. Equity compensation
   C. Future add-on acquisitions
   D. Exit

Negotiating the Purchase Agreement: Seller Tax Objectives

I. Long term capital gain treatment
II. Increase purchase price
    A. Tax step-up
    B. Tax attributes
III. Installment sale treatment
IV. No withholding taxes

Negotiating the Purchase Agreement: Tax Provisions

I. Risk Allocation
   A. Historical tax liabilities/assets
   B. Future tax liabilities/assets
   C. Acquisition tax liabilities/assets
II. Review entire agreement
III. Recitals/transfer provisions
IV. Representations and warranties

Negotiating the Purchase Agreement: Tax Provisions

V. Tax Covenant
   A. Tax return preparation
   B. Tax indemnity/refunds
   C. Tax cooperation
   D. Tax audits
   E. Elections/amendments
   F. Transaction tax benefits

Negotiating the Purchase Agreement: Tax Provisions

VI. Simultaneous sign and close vs. delayed closing (pre-closing covenants)

VII. Purchase price allocation for asset deals

VIII. Working Capital

  A. Taxes included or excluded?

  B. Interaction with other tax provisions (no double counting)

Negotiating the Purchase Agreement: Tax Provisions

IX. Tax Indemnity

A. Pre-closing taxes
B. Taxes of others (e.g., 1.1502-6 liability)
C. Post-closing taxes
D. No double counting
E. Target classification
F. Limitations and interaction with general indemnity (caps, floors, deductible, etc..)

Negotiating the Purchase Agreement: Tax Provisions

IX. Tax Indemnity
    G. Timing for collection

X. Tax benefit offset to losses

XI. Rep and warranty insurance

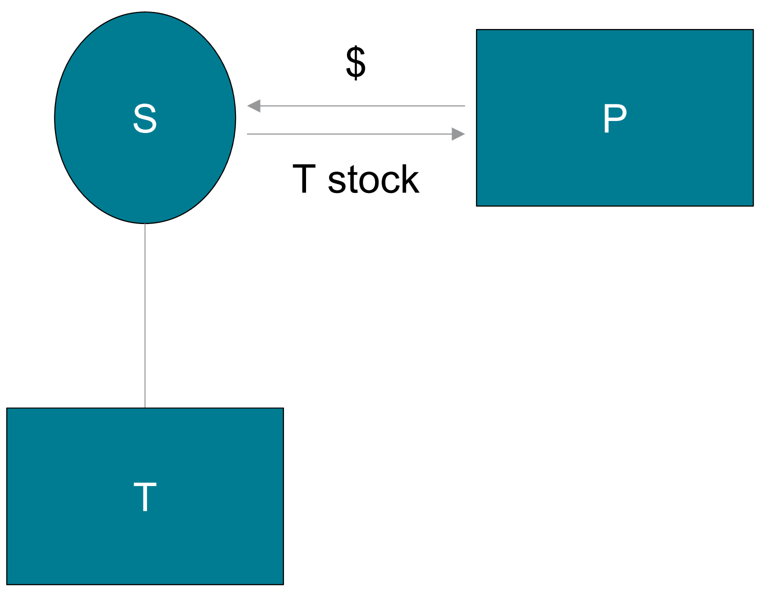
XII. Firpta certificate

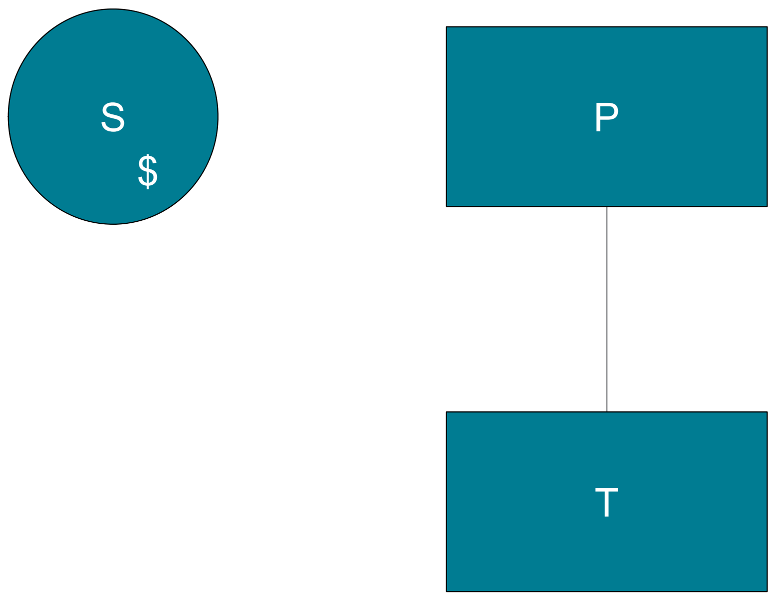
XIII. Transfer taxes

Introduction: Stock Acquisition – Business Issues

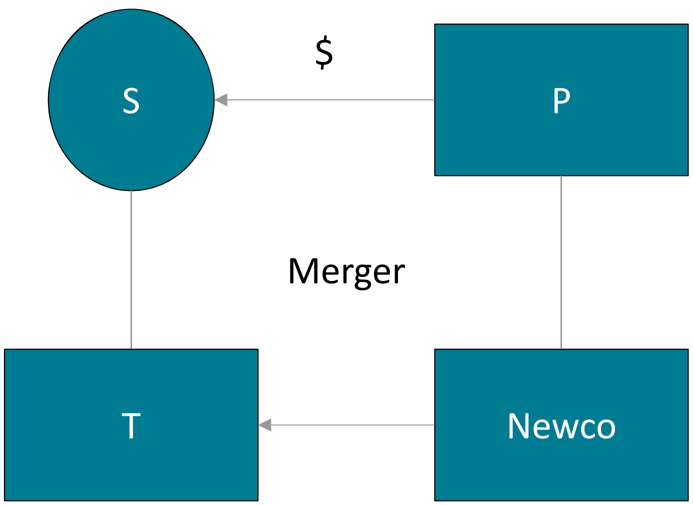
- **Business Issues**
  - All Target (T) liabilities acquired/T liabilities isolated
  - Must move unwanted assets out of T (or wanted assets into T)
  - Minimal asset transfer issues
  - Tax rules generally don't limit the type of consideration
    - All-voting-stock consideration may be a reorganization
  - Tax rules generally don't limit post-acquisition planning
    - Post-purchase liquidation/merger can cause acquisition to be a reorganization; see Rev. Rul. 2001-46, 2001-2 C.B. 321
- **General Rules**
  - Shareholders recognize gain or loss on each share of stock sold
    - Difference between amount realized on the share and the basis in the share
  - Acquiring gets a cost basis in each share
  - T survives the stock sale intact
    - No change to inside asset basis
    - No change to tax attributes, though the future use of the attributes to offset income or tax liability may be limited (e.g., Section 382)
    - No change in tax history (e.g., ability to carryback future losses to pre-acquisition taxable years)

Introduction: Direct Stock Acquisition

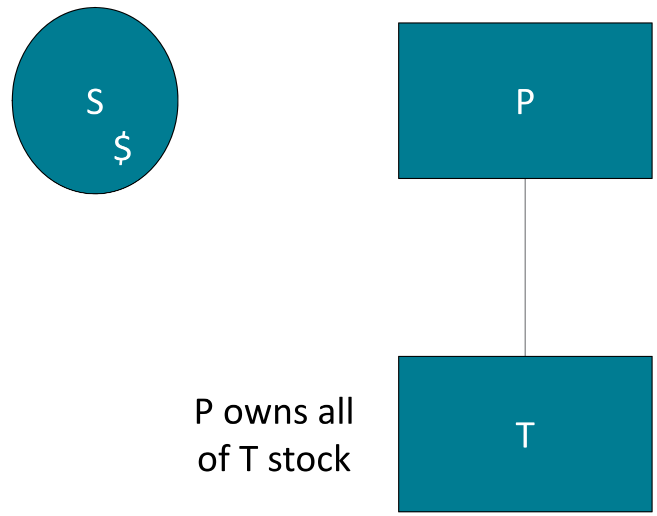




Introduction:
Indirect Stock Acquisition – Reverse Subsidiary Cash Merger

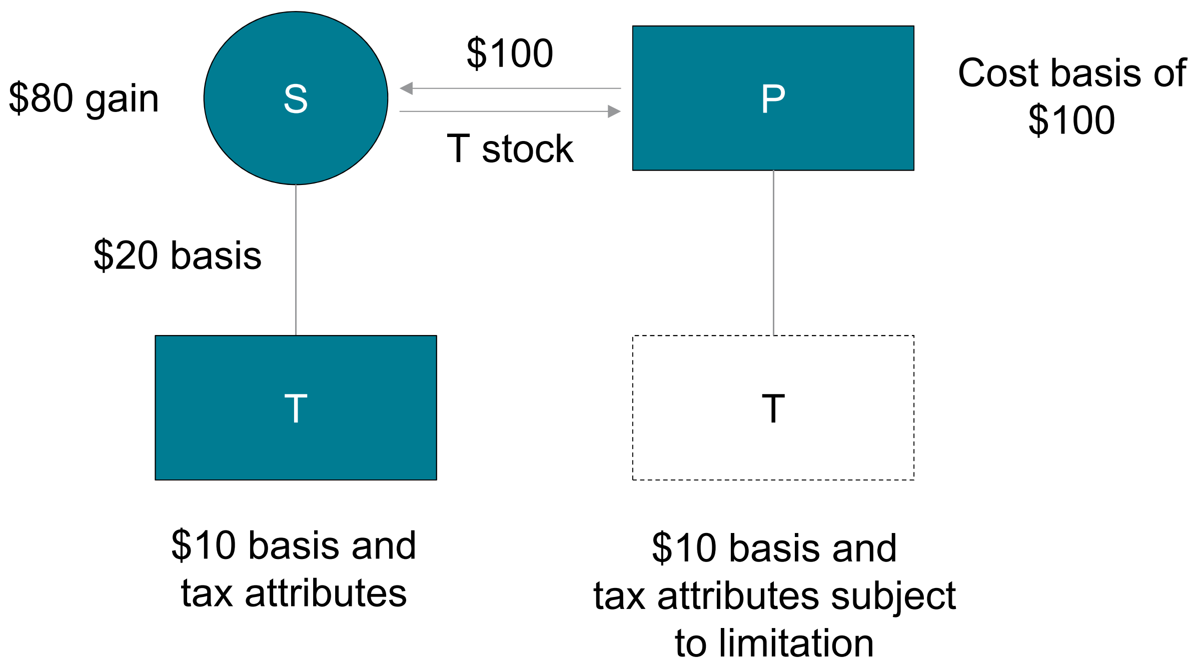


T shares convert to $



** See Rev. Rul. 90-95, 1990-2 C.B. 67.

Introduction:
Stock Acquisition – Tax Effects

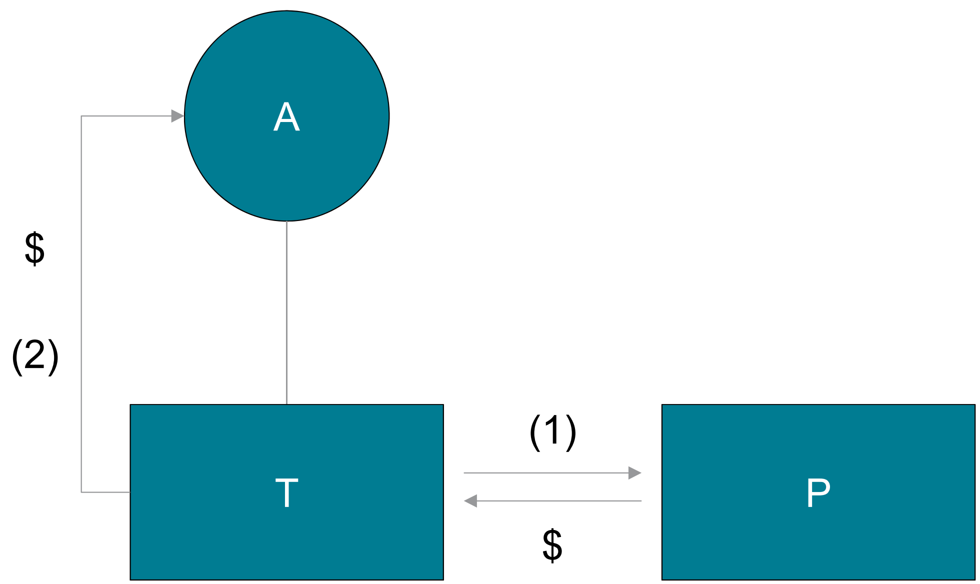


Introduction:
Asset Purchase

Business Issues

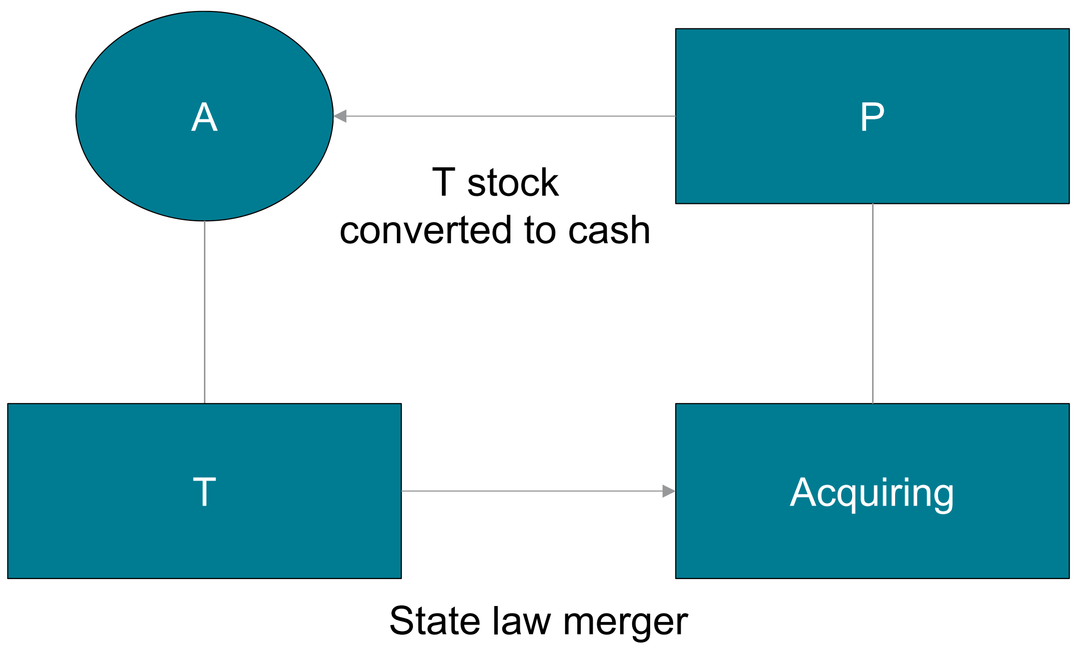
- Significant title transfer issues
- Need not assume liabilities (unless merger)
- Only need sell/buy wanted assets
- Tax rules don't limit type of consideration
  - But if more than 38% stock, may be a tax-free reorganization, if selling corporation is liquidated
- Federal tax rules don't generally limit post-acquisition planning (state tax laws should be considered)

Introduction:
Purchase of Subsidiary Assets



(1) Sale of assets.
(2) Distribution of proceeds.

Introduction:
Alternative Merger Structure - Forward Subsidiary Cash Merger



Treated as if T sold assets to Acquiring and T liquidated,
See, Rev. Rul. 69-6, 1969-1 C.B. 104

Introduction: *Compare Forward Subsidiary Cash Merger With Asset Sale*

Both alternatives result in:

- Stepped-up basis in T assets
- Two levels of tax
- Any unused T NOLs disappear

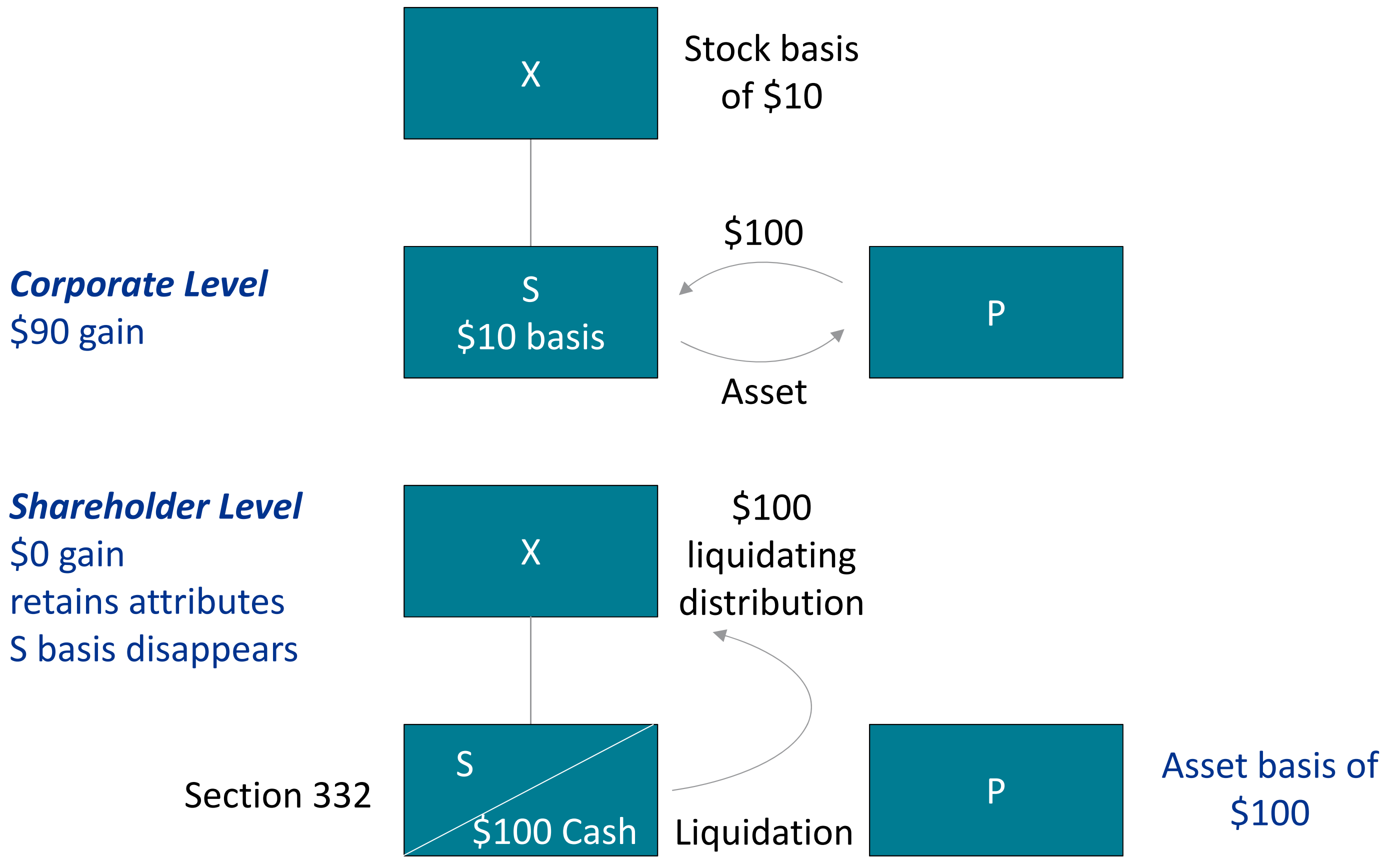
Merger

- Requires both T shareholder and Acquiring shareholder approval
- No re-titling of assets
- Acquiring has unlimited liability exposure

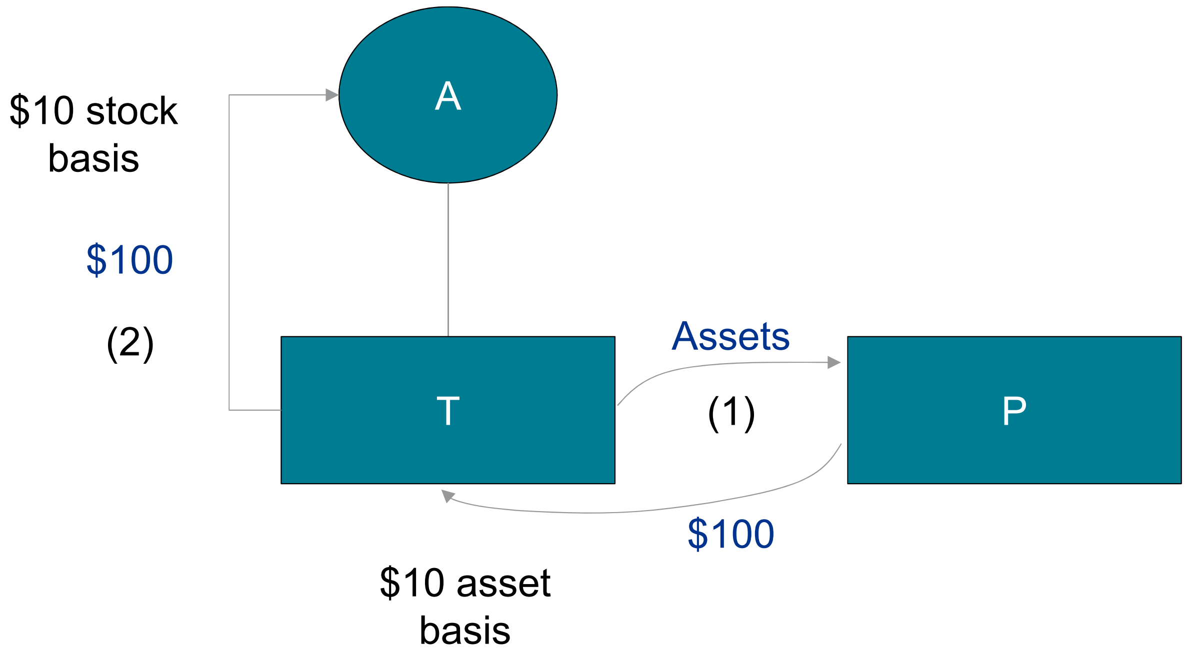
Direct Asset Sale

- Only T shareholder approval
- Acquiring assumes specific T liabilities

Introduction:
Purchase of Subsidiary Assets - Tax Effects

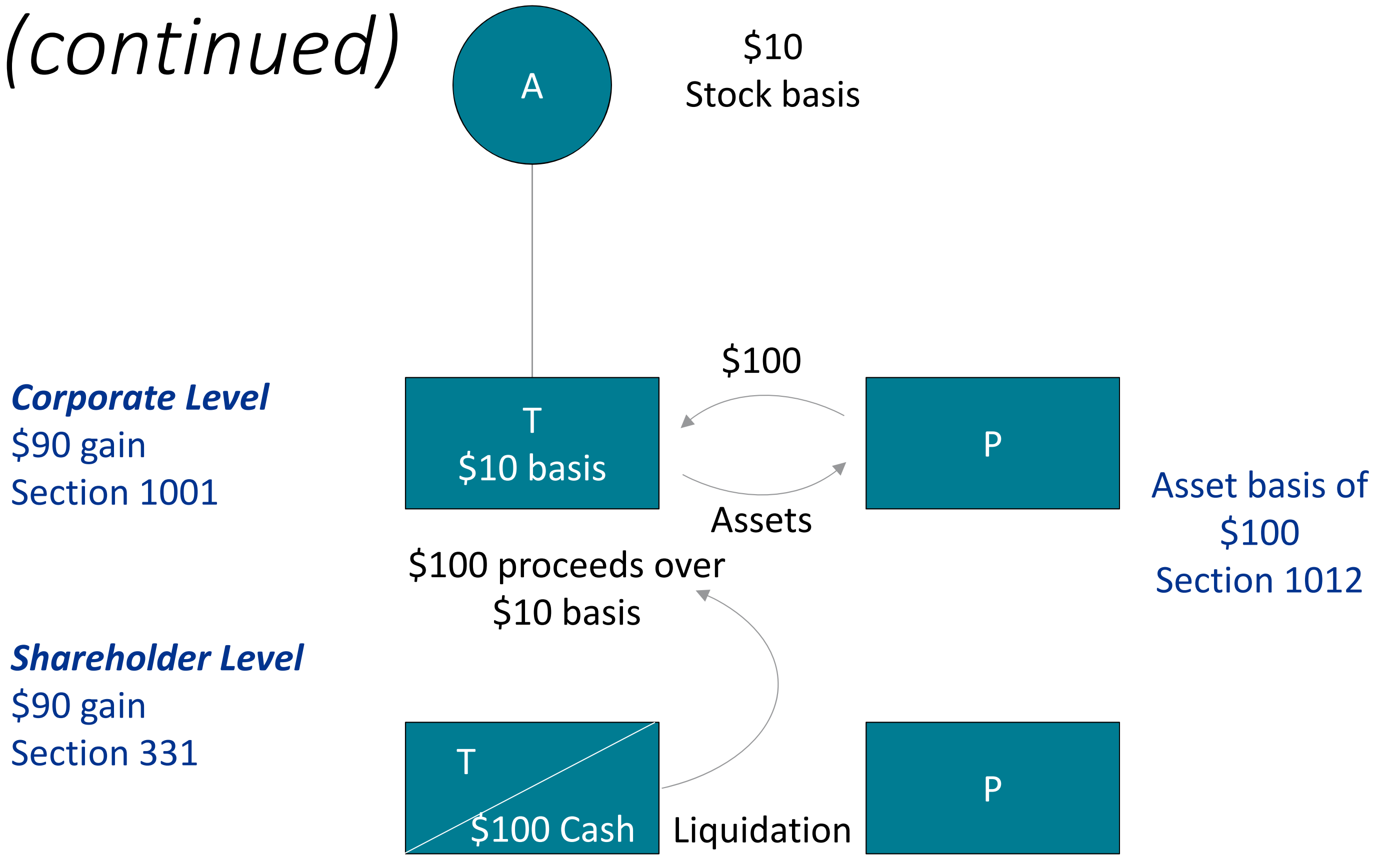


Introduction:
Purchase of Stand-alone Corporation's Assets - Tax Effects



(1) Sale of assets.
(2) Distribution of proceeds.

Introduction:
Purchase of Stand-alone Corporation's Assets - Tax Effects (continued)



Introduction:
Types of tax risk: *Corporations*

Federal	State	City/County	Foreign
■ Income ■ Employment	■ Income ■ Franchise ■ Gross receipts ■ Sales/use ■ Real/Personal property ■ Employment ■ Miscellaneous excise taxes ■ Unclaimed property	■ Property ■ Income ■ Sales/use ■ Business license/gross receipts ■ Miscellaneous (e.g., NYC Commercial Rent Tax)	■ Income ■ Social/payroll ■ Property ■ VAT

Introduction:
Types of tax risk: *S corporations*

Federal	State	City/County
▪ Income (dependent on quality and timing of S status) ▪ Employment	▪ Income (dependent on state treatment of S corporations) ▪ Franchise ▪ Gross receipts ▪ Sales/use ▪ Real/Personal property ▪ Employment ▪ Miscellaneous excise taxes ▪ Unclaimed property	▪ Property ▪ Income ▪ Sales/use ▪ Business license/gross receipts ▪ Miscellaneous (e.g., NYC Commercial Rent Tax)

Introduction:
Types of tax risk: *Partnerships*

Federal	State	City/County
▪ Employment	▪ Income (dependent on state treatment of partnerships) ▪ Franchise ▪ Gross receipts ▪ Sales/use ▪ Real/Personal property ▪ Employment ▪ Miscellaneous excise taxes ▪ Unclaimed property	▪ Property ▪ Income ▪ Sales/use ▪ Business license/gross receipts ▪ Miscellaneous (e.g., NYC Commercial Rent Tax)

Introduction:
Types of tax risk: *Disregarded entities*

Federal	State	City/County	Foreign
▪ Employment	▪ Income (dependent on state treatment of DRE) ▪ Franchise ▪ Gross receipts ▪ Sales/use ▪ Real/Personal property ▪ Employment ▪ Miscellaneous excise taxes ▪ Unclaimed property	▪ Property ▪ Income ▪ Sales/use ▪ Business license/gross receipts ▪ Miscellaneous (e.g., NYC Commercial Rent Tax)	▪ If U.S. DRE owns a foreign entity, local country taxes may carryover in the acquisition of a U.S. DRE

Introduction:
Types of tax risk: *Assets*

Federal	State	City/County	Foreign
■ Employment (dependent on state law doctrine of successor liability)	■ Sales/use ■ Real/Personal property ■ Gross receipts ■ Unclaimed property ■ Dependent on successor liability statutes within the states: – *Income* – *Franchise* – *Employment*	■ Property ■ Sales/use ■ Business license/gross receipts ■ Miscellaneous (e.g., NYC Commercial Rent Tax, etc.)	■ If one of the assets acquired is a foreign entity, local country taxes may carryover in the acquisition of U.S. assets