

# TAX ASPECTS OF PURCHASING AND SELLING INDEPENDENT SALES REPRESENTATIVE ORGANIZATIONS

## I. Purchases and Sales of Assets

### A. Asset Purchase and Sale Transactions

#### 1. C Corporation – Corporation is party that sells assets to third party

a. Corporation pays tax on difference between selling price of each asset and tax basis of each asset

b. Second level of tax (double tax) occurs when assets of C corporation are distributed to shareholders in liquidation

Example 1: Brees, a C corporation, owns assets with a tax basis of \$1,000,000. Drew, Brees's sole shareholder, has a \$10,000 basis in his Brees shares. Brees sells its assets to Winston for \$3,000,000. Brees will report a gain of \$2,000,000 (\$3,000,000 gross proceeds less \$1,000,000 tax basis) and pay 41.75% tax<sup>1</sup> on gain. Brees will then distribute after-tax proceeds of \$2,165,000 to Drew who will pay 27.55% tax<sup>2</sup> on difference between \$2,165,000 received and \$10,000 basis in his Brees stock leaving Drew with after-tax proceeds of \$1,571,298.

c. Purchaser takes tax basis in each asset acquired which equals consideration allocated to each asset purchased

#### 2. S Corporation – Corporation is party that sells assets to third party

a. Corporation does not pay tax on gain from sale but gain passes through and reported by shareholders

b. Basis of each shareholder's stock increased by gain reported so ensuing liquidating distribution by corporation does not create double tax.

Example 2: Romo, a S corporation, sells its assets having a tax basis of \$1,000,000 for \$3,000,000. Romo reports a \$2,000,000 gain from the sale which passes through and is reported by Romo's sole shareholder, Tony. Following sale, Romo distributes \$3,000,000 of sale proceeds to Tony. Tony increases basis in his Romo stock by \$2,000,000 reported gain so \$2,000,000 gain from sale is only taxed once, not twice.

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<sup>1</sup> Assumed 34% Federal tax and 7.75% Illinois tax

<sup>2</sup> Assumed 20% Federal income tax, 3.8% Federal net investment income tax and 3.75% Illinois income tax

c. Character of gain important as gain from sale of capital assets results in capital gain while gain from sale of non-capital assets results in ordinary income.

3. Limited Liability Company (“LLC”)/Partnership (collectively “Company”) – Company is party that sells assets to third party

a. Company does not pay tax on gain from sale but gain passes through and reported by Company owners

b. Basis of each owner’s interest increased by gain reported so ensuing liquidating distribution by Company does not create double tax

c. Character of gain important as gain from sale of capital assets results in capital gain and gain from sale of non-capital assets results in ordinary income

B. Allocation of Sale Proceeds

1. Consideration from asset sales allocated based on fair market value of each asset sold with excess allocated to goodwill

2. Classes for which consideration allocated:

a. Class 1 – Cash/cash equivalents exclusive of certificates of deposit

b. Class 2 – Marketable securities and other actively traded personal property including certificates of deposit

c. Class 3 – Accounts and other receivables

d. Class 4– Inventory and other stock in trade

e. Class 5 – All assets not allocated above excepting intangible assets

f. Class 6 – All intangible assets excepting goodwill and going concern value

g. Class 7 – Goodwill and going concern value

3. Buyer and seller must reach agreement as to how consideration allocated

4. Allocation Preferences

a. Non-C corporation sellers prefer allocating consideration to assets which result in capital gain, not ordinary income

b. Purchasers prefer allocating consideration to assets which can be depreciated or amortized over shortest possible time period (e.g., machinery and equipment)

Example 3: Cutler, a S corporation, sells its assets consisting primarily of accounts receivable and goodwill to Bradford. Any gain attributable to sale of accounts receivable will be taxable as ordinary income while any gain attributable to sale of goodwill will be taxable as capital gain. Shareholders of Cutler prefer maximizing allocation of sale proceeds to goodwill and minimizing allocation to accounts receivable. Bradford prefers maximizing allocation to accounts receivable which will result in faster write-off than allocation to goodwill which must be amortized over 15 year period.

### C. Avoiding Double Tax to C Corporations and Shareholders

#### 1. Allocations outside of purchase and sale agreement

a. If shareholders of selling corporation are retained as employees of purchasing entity, some portion of sale proceeds can be allocated to employment agreements of retained shareholders, thereby decreasing amount subject to double tax

Example 4: Assume in Example 1 that Drew will be retained by Winston as an employee. Originally Drew agreed to stay on as an employee receiving a nominal salary for services rendered. If it is determined that Drew can instead receive a salary of \$500,000 for two years of time he will be working for Winston, parties can potentially reduce sale proceeds of \$3,000,000 to \$2,500,000 and allocate \$500,000 shortfall as an additional employment agreement compensation to Drew. This will serve to reduce amount subject to double tax which will provide benefit to both Drew and Winston.

b. Similarly, if shareholders of selling corporation are retained as consultants or independent contractors of purchasing entity, some portion of sale proceeds can be allocated to consulting agreements to decrease amount subject to double tax

c. If shareholders of selling corporation agree to refrain from competing with purchasing entity following sale, allocation of consideration to non-competition covenant can serve to reduce double tax

#### 2. Payments from selling corporation

a. Reasonable bonuses can be paid to shareholders of selling corporation thereby decreasing amount subject to double tax

Example 5: Assume same facts as in Example 1 except prior to making a liquidating distribution to shareholders, Brees pays bonus of \$300,000 to Drew for services rendered. This will reduce amount of double tax as bonus will reduce gain reported by Brees with bonus treated as deductible expense.

b. If selling corporation has deferred compensation plan in place, decrease in double tax can occur if deferred compensation is paid to shareholders of selling corporation

### 3. Personal Goodwill

a. If goodwill of business largely attributable to shareholders of selling corporation rather than selling corporation itself, shareholders can separately sell their personal goodwill and personally receive some portion of sale proceeds, thereby decreasing amount subject to double tax

b. Shareholders selling personal goodwill individually report capital gain on amount of personal goodwill sold

c. To establish personal goodwill:

(i) Seller must demonstrate goodwill is attributable to selling shareholder(s), not to selling entity

(ii) Selling shareholder(s) must not be bound by non-compete with selling corporation

(iii) If more than one selling shareholder, payment attributable to personal goodwill should not be equally shared by shareholders

(iv) Separate purchase and sale agreements should be in place for sale of personal goodwill

(v) Separately identify personal goodwill in letter of intent

Example 6: Assume same facts as in Example 1 except parties believe that \$1,000,000 of \$3,000,000 sale proceeds is reasonable allocation to personal goodwill of Drew. In this case, only \$2,000,000 will be paid to Brees and \$1,000,000 will be paid to Drew personally. This will not only reduce amount of gain subject to double tax by \$1,000,000 but will also provide for \$1,000,000 to be paid to Drew as personal goodwill, taxable as capital gain.

## D. S Corporation Conversions

1. Code restricts benefits of C corporation converting to S corporation immediately prior to sale to avoid double tax

a. Built-in gain tax imposed on S corporation that formerly was C corporation that disposes of assets with "built-in gain" during "recognition period"

b. Built-in gain measured at time corporation converts from C corporation status to S corporation status

c. Recognition period is five year period that begins when C corporation becomes S corporation

2. Assets of converting C corporation should be appraised at time of conversion to establish amount of built-in gain

3. Conversion to S corp status at least five years prior to sale will avoid double tax

## II. Sales of Stock and Other Ownership Interests

### A. Stock Purchase and Sale Transactions

1. Owners sell interests in selling entity and purchaser acquires ownership of operating business

2. Corporate shareholders sell stock in stock purchase and sale transaction

3. Company owners sell partnership interests in partnership or membership interests in LLC

4. Purchasing parties continue to operate business in same entity

### B. Tax Consequences of Corporate Stock Sales

1. Selling shareholders report taxable gain based on difference between amounts received from sale and tax basis in their shares

2. Basis of shares of C corporation shareholder is amount shareholder paid for shares increased by additional contributions shareholder makes to corporation

3. Basis of shares of S corporation shareholder is amount originally paid for shares increased by additional contributions shareholder makes to corporation, further increased by shareholder's allocable share of corporate

income and decreased by shareholder's allocable share of corporate losses and further decreased by corporate distributions received by shareholder

4. Gain from sale treated as capital gain and, if shares held for period of more than one year, capital gain is long-term capital gain

5. Depending on selling shareholder's income and other items, selling shareholder could be subject to net investment income tax on gain realized from sale

Example 7: Consider same facts in Example 1 except that Drew sells his Brees shares for \$3,000,000. Drew will report a capital gain of \$2,990,000 (\$3,000,000 of sale proceeds less \$10,000 stock basis) on share sale and will pay 27.55% tax<sup>3</sup> of \$823,745 leaving after-tax sale proceeds of \$2,176,255. If instead Drew sold his Brees stock for \$2,500,000, Drew would receive after-tax proceeds of \$1,814,005.

6. Purchaser acquires basis in purchased shares equal to purchase price paid, which amount cannot be depreciated nor amortized.

#### C. Tax Consequences of Sales of Company Interests

1. Gain or loss from sale of ownership interest in Company generally treated as capital gain or loss

2. In considering both amounts realized from sale and basis of Company interest sold, selling owner must take into account selling owner's share of Company liabilities

3. Amounts realized from sale attributable to unrealized receivables and inventory items treated as ordinary income

a. Unrealized receivables include accounts receivable not previously included in income and recapture of depreciation from assets sold

b. Inventory items consists of stock in trade and other assets which do not constitute capital assets

Example 8: Dalton acquires 50% membership interest of Manning in Manning-Rodgers, a limited liability company, for \$1,000,000. Manning-Rodgers has \$500,000 of unrealized accounts receivable. \$250,000 of \$1,000,000 amount realized by Manning must be treated as sale of Manning-Rodgers unrealized accounts receivable.

#### D. S Corporation and Company Income Allocation Issues

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<sup>3</sup> Assumed 20% Federal income tax, 3.8% Federal net investment income tax and 3.75% Illinois income tax

1. Income and loss of S corporation and Company passed through and taxed to entity owners
2. Income generally allocated on pro rata basis based on number of days in year which could create trap for unwary
  - a. Selling owners could be taxed on post-sale income
  - b. Purchasing party could be taxed on pre-sale income

Example 9: Wilson, a S corporation, earns \$1,000,000 of revenue during calendar year 2016, \$300,000 of which is earned from January 1 through June 30 and \$700,000 of which is earned from July 1 through December 31. Wilson's sole shareholder, Russell, sells his stock to Cousins as of close of business on June 30. Russell will report \$500,000 of income for 2016 which will be taxable to him.

3. Parties should consider election to treat S corporation/LLC year as if it closed as of date of sale to minimize opportunity for phantom income

Example 10: Assume same facts as in Example 9 except that parties decide to make an election to close books of Wilson as of close of business on June 30, 2016. In this case, Russell will only report \$300,000 of income for 2016 calendar year and remaining \$700,000 of income will be allocated to and reported by Cousins.

4. Selling owners might also ask for distributions from sold entity to cover tax liability attributable to phantom income

#### E. Other Issues

1. Net Operating Loss Limitations - Accumulated losses of C corporation (net operating losses or NOLs) can offset income of entity for future years
  - a. Where stock sale occurs with entity with meaningful NOLs purchaser must be mindful of restrictions on application of net operating losses against post-sale income
  - b. If meaningful NOLs exist, consider alternative transaction structure
2. Section 1244 Stock - Stock of certain "small business corporations" sold at loss may yield ordinary loss on stock sale, subject to certain limitations

3. Small Business Stock - Gain from sale of qualified small business stock held for more than five years can be excluded from income of selling shareholders

4. Basis Step-Up Transactions - If purchaser and seller so elect, corporate purchase of domestic S corporation can be treated as acquisition of target corporation's assets rather than acquisition of target corporation's stock, thereby permitting purchasing entity to acquire higher basis in shares acquired

#### F. Overall Considerations

1. Sellers typically prefer stock sale to asset sale

a. Stock sale avoids double tax for C corporation seller

b. Stock sale more likely to result in capital gain

2. Purchasers typically prefer asset purchases to stock purchases

a. Asset purchases protect purchased business from continued responsibility for liabilities of selling entity

b. Asset purchases often provide purchasing entity with higher basis of assets purchased which permit them to enjoy tax benefits from larger depreciation and amortization deductions

Example 11: Phillip desires to purchase all of the outstanding shares of Rivers for \$3,000,000. Phillip will not be able to amortize any portion of the purchase price. If instead, Phillip purchases assets of Rivers for \$3,000,000 and \$2,500,000 is allocated to goodwill, \$2,500,000 allocated to goodwill can be amortized and deducted over a 15 year period.

### III. Corporate Redemptions of Sharehold Interests

#### A. Corporate Stock Redemption Rules in General

1. If corporation redeems (e.g. purchases) its stock held by shareholder of corporation, redemption can be treated as dividend or as payment in exchange for shareholder's stock

2. If payment treated as dividend, selling shareholder reports gross payment as dividend which will be taxable at dividend tax rates to extent of C corporation's accumulated earnings and profits

3. If payment deemed made in exchange for stock, selling shareholder treats gain or loss as capital gain or loss

4. Constructive Ownership Rules

a. Shareholders deemed to own shares owned by certain family members

b. Constructive ownership of another's stock can prevent qualification for sale or exchange treatment

5. Four safe harbors, satisfaction of any of which, will result in capital transaction for selling shareholder

B. Not Essentially Equivalent to Dividend

1. Various cases and rulings address when distribution not essentially equivalent to dividend but due to subjectivity, this safe harbor rarely utilized

2. If shareholder's ownership decreases to 50%, then safe harbor may apply.

C. Substantially Disproportionate Redemption – Two components of safe harbor

1. Following redemption, redeemed shareholder must own less than 50% of combined voting power of all classes of corporation's stock

2. Percent of corporation's voting stock owned by redeemed shareholder following redemption must be less than 80% of shareholder's percentage ownership of voting stock of corporation prior to redemption

Example 12: Palmer, a C corporation, has three unrelated shareholders, each owing 1,000 shares of corporation's sole class of stock. If Palmer wishes to redeem 300 shares of stock held by Carson, one of its shareholders, distribution will constitute substantially disproportionate redemption as percentage of shares owned by Carson after redemption  $((1,000 - 300) \div 2,700)$  (25.92%) is less than 80% of Carson's percentage ownership before redemption which is  $(1,000 \div 3,000 = 33 \frac{1}{3} \%)$ .

D. Complete Termination of Sharehold Interest

1. Complete termination of shareholder's interest means shareholder no longer owns stock of corporation.

2. Most complete terminations would fall within not essentially equivalent to dividend or substantially disproportionate redemption safe harbors except for constructive stock ownership rules

3. Complete termination safe harbor will apply if, after redemption, shareholder no longer has any interest in corporation as officer, director or

employee, does not acquire any such interest within ten years of redemption and shareholder agrees to notify IRS if shareholder acquires such prohibited interest within such period

Example 13: Luck, a C corporation, is owned equally by two shareholders, Andrew Sr. and Andrew Jr. Under constructive ownership rules, Andrew Sr. is deemed to own all shares owned by Andrew Jr. and Andrew Jr. is deemed to own all shares owned by Andrew Sr. If Luck redeems all of Andrew Sr.'s shares, redemption will not satisfy substantially disproportionate redemption safe harbor as Andrew Sr. still deemed to own Andrew Jr.'s shares.

#### E. Partial Liquidations

1. To qualify as partial liquidation, distribution must not be essentially equivalent to a dividend.

a. In connection with conduct of corporation's qualified trade or business, corporation must no longer conduct such qualified trade or business following redemption

b. Corporation must also engage in active conduct of trade or business following redemption

c. Qualified trade or business is business actively conducted by corporation for five year period immediately ending on date of redemption

2. Distribution must occur within taxable year in which plan of liquidation is adopted or within succeeding taxable year.

#### IV. Redemptions of Company Interests

##### A. General rules

1. Gain not recognized on distributions to owners except to extent money received exceeds redeemed owner's basis in Company interest

2. Losses not recognized on distribution except on liquidating distribution if no property other than money, unrealized receivables and inventory distributed, losses can be recognized to extent basis of redeemed owner's interest in Company exceeds sum of money distributed and owner's basis in unrealized receivables and inventory

3. Money received includes not only cash distributions but marketable securities which are valued at fair market value on date of distribution

##### B. Treatment of Cash Distributions to Redeemed Owner

1. Redemption proceeds treated in one of three ways:
  - a. Redemption proceeds are treated by owner as ordinary income as distributive share of Company income if payments determined with respect to Company income
  - b. Redemption payments treated by owner as ordinary income as guaranteed payment if payments determined without regard for Company income
  - c. Redemption payments treated by owner as paid in exchange for assets of Company which will be treated as proceeds from sale of Company interests
2. Payments attributable to interests in company (B1c above) must further be analyzed to determine proper treatment
  - a. Portion of payments allocable to unrealized receivables, inventory and other non-capital assets must be treated as ordinary income while portion allocable to other assets treated as capital gain
  - b. Redemption payments can only be treated as allocable to goodwill if Company agreement so provides and if capital of Company was not a material income producing factor and redeemed owner was not a general partner

## V. Tax-Free Mergers of Corporations

### A. General Consequences

1. No gain or loss recognized upon receipt and exchange of securities except when cash or other consideration received in addition to stock or securities
2. If additional consideration received, gain recognized but not in excess of cash and fair market value of other (non-securities) property received

### B. Standard A Reorganization

1. Statutory mergers of one corporation into another corporation whereby one corporation retains corporate existence and absorbs other corporation in merger
2. Surviving corporation assumes liabilities of merged corporation as matter of law

### C. Subsidiary Merger

1. Concerns about liabilities of target corporation can be minimized with use of subsidiary in merger

2. Forward Merger – Acquiring corporation creates subsidiary and target corporation merges into subsidiary with target corporation shareholders receiving acquiring corporation stock

Example 14: Brady, a C corporation, wishes to merge into Newton, a C corporation, but Newton does not wish to assume Brady's liabilities. Newton creates a wholly-owned subsidiary, Ryan, and Brady is merged into Ryan, Newton shares issued to Brady's shareholders.

3. Reverse Merger – Acquiring corporation creates subsidiary and merges subsidiary into target corporation with target corporation shareholders receiving acquiring corporation stock in return

Example 15: Assume same facts as in Example 14 except parties wish for Brady to remain in existence. Newton creates Ryan which is merged into Brady. Brady's shareholders receive Newton stock in return.

D. Other Requirements of Tax-Free Reorganizations - Reorganizations will not be afforded tax-free status unless certain additional requirements are satisfied

1. Business Purpose- Bona fide purpose to transaction must be established

2. Continuity of Interest – Stockholders of target corporation must receive requisite percentage of stock in acquiring corporation

3. Continuity of Business Enterprise – Acquiring corporation must either continue at least one significant line of target corporation's historic business or use in its business a significant portion of target corporation's historic business assets

4. Step Transaction – Series of formal separate steps not treated as single transaction if each step is meaningful and has independent significance