A Primer on Buying or Selling a Business

Buying or selling a business can be a wonderful, terrifying experience. Many who seek our assistance have never been through a business acquisition, and they may have no idea what to expect. As with any business activity, a sale or acquisition requires careful planning. It is best to view the sale as a process that can be broken down into individual steps, each to be taken in turn. Of course, as with life, the deal is what happens while we're busy making plans. Still, a few basic guidelines may save a lot of time and heartache and (heaven forbid) attorneys' fees.

1. Kicking the Tires. A potential buyer will want to inspect the business and its records. The buyer should work with his or her advisors in preparing a "due diligence" checklist of information to be requested from the seller. Public records should be searched to determine if there are any tax liens, judgments, suits, bankruptcy proceedings or security interest filings against the company or its assets.

At the same time, the well-advised seller will not release any proprietary information unless the buyer is willing to sign a nondisclosure agreement.

2. The Napkin Agreement. At some point, the parties believe they have a "deal." This may a good time to prepare a letter of intent (LOI) or term sheet outlining the basic terms. This can be a very short and informal ("back of the envelope") document. It may be a useful tool for confirming agreement on basic terms while identifying any major areas of disagreement. The effort spent on a LOI can force to the surface major issues *before* too much time, money and emotional capital is invested in negotiating a formal contract. On the other hand, the LOI should not be allowed to take on a life of its own. At some point, the parties will be better served by turning their attention to negotiating the contract of sale.

The LOI is usually intended to be non-binding, but if it is not carefully written it may actually constitute a binding contract. There has been much litigation over this very issue. To avoid legal disputes, include language that the LOI is non-binding and for discussion purposes only.

3. Asset Sale vs. Stock Sale. Whether the transfer takes the form of a stock sale or asset sale is a key term that should be decided at the letter of intent stage. In a stock sale, the company is acquired intact; only the owners change. All liabilities remain with the company, including contracts, potential lawsuits, tax liabilities, employee benefits, etc. To avoid assuming unknown liabilities, the buyer may prefer an asset sale, or, in the alternative, will ask that company liabilities be fully disclosed in the sale contract. Sellers are generally expected to make more representations and warranties in a stock sale.

The ultimate decision on the structure of the deal depends in large part on a number of competing tax planning considerations. For tax-planning purposes, sellers tend to prefer stock sales, and buyers tend to find prefer asset sales.

First, the seller may propose a stock sale to avoid double taxation. The selling corporation would be taxed on the sale price, and the stockholders would be taxed when they receive distributions of sale proceeds from the corporation. Whether there is double taxation depends on whether the corporation is a "C" corporation or an "S" corporation with "built-in" capital gains. By contrast, there is no double taxation in a stock sale since stock and not assets are being purchased. Consequently, 100% of the sale proceeds are paid directly to the stockholders rather than the selling entity.

Secondly, in an asset sale, the seller may be subject to recapture tax on depreciated assets.Recapture tax is at ordinary income tax rates rather than the lower capital gains rates the seller may receive in a stock sale.

Thirdly, in an asset sale, the buyer and seller would negotiate the allocation of the purchase price among the various sale assets. Bear in mind that an asset sale is not a

sale of the company, but rather a sale of a collection of individual assets. There is usually one purchase price, and parties agree in the contract of sale to allocate that price among the various categories of assets. The buyer may want to allocate more of the price to assets that can be depreciated over a relatively short life, allowing higher annual tax deductions. Assets that fall into this category include "hard" assets such as equipment. Good will and other intangible assets tend to be amortizable over a longer period, which provides the buyer with less favorable tax treatment. On the other hand, to the extent the price is allocated to these intangible assets, the seller will be taxed at the lower capital gains rates, rather than the higher recapture tax rates imposed on the sale of equipment. There is no issue of asset allocation in a stock sale. Fourthly, in an asset sale, sales taxes would be imposed on the amount of the purchase price allocated to equipment and other hard assets (other than inventory that was purchased for resale). Real estate transfer taxes would also be imposed on any real estate being conveyed. There are no such transfer taxes in a stock sale, since no company assets are being sold. The seller can mitigate the effect of sales taxes by pushing to have less of the purchase price allocated to hard assets (which has the added benefit of reducing recapture taxes), or requiring the buyer to pay a greater share (or all) of the sales tax.

There are other considerations to be weighed, which are beyond the scope of this article. Hopefully, this gives you some sense of the importance of tax issues in any transaction and the need to consult early on with your tax advisors.

4. The Sale Contract. Once the major deal terms are nailed down, the buyer and seller can begin putting together a formal contract of sale. This can be a rigorous contest of allocating risks between the parties.

Some of the most hotly negotiated contract provisions are the representations and warranties made by the seller. The buyer will want as much recourse as possible against the seller if there are any post-closing hiccups. The seller, on the other hand, will want to minimize his or her personal liability in the transaction. In the best of all seller worlds, the sale contract will provide for an "as is" sale, shifting risk to the buyer and compelling the buyer to make a thorough due diligence investigation.

The buyer, wanting to hedge his or her investment risk as much as possible, will tend to ask for as many warranties as possible. At a minimum, the seller should expect to make certain basic warranties (e.g. that there are no liens on the assets, that tax returns and financial statements are accurate, and that the seller has disclosed any current litigation). On the other hand, the seller is not an insurance company and should not be expected to underwrite the buyer's business risks.

As a compromise, the buyer may suggest holding back some of the purchase price, either in escrow or under promissory note, in order to secure the seller's liability for breach of warranties while not imposing too much liability risk on the seller.

It may be good strategy to make it clear up front (i.e. in the letter of intent) the warranties the buyer expects and the ones the seller is willing to give.

5. Consulting and Non-Competition Covenants. The buyer may want the seller to continue on as a consultant, in which case a portion of the "sale price" may be in the form of consulting fees—a currently deductible expense to the buyer. Unfortunately, these fees would be in the form of ordinary income to the seller, rather than capital gains.

The seller may also be asked to sign a covenant not to compete. Again, part of the monies paid to the seller may be treated as a fee for this covenant.

NOTE: At this point, you may notice a pattern in a tax benefit for one party tends to be a tax detriment to the other. To some extent, the IRS will respect the agreement because the IRS tends to come out ahead either way, assuming the parties file consistent tax returns. The IRS ensures this consistency by requiring both parties in an asset sale to file IRS Form 8594 (Asset Acquisition Statement) with the next year's tax returns, reporting the purchase price allocation agreed to by the parties.

6. Payment Terms. Lucky is the seller who can negotiate a cash deal. No matter how airtight the documentation, a seller always takes a big risk by financing the deal. (Advice to live by: Only accept paper bearing pictures of presidents.)

Often the seller is forced to finance at least a portion of the purchase price, especially if the buyer cannot qualify for bank financing. The buyer may also be motivated to defer payment of the price as a way of holding back some of the price to secure any liability of the seller for breach of warranties, as discussed above.

One advantage of a seller-financed deal is the potential to defer taxes until payments are actually received (an "installment sale"). Rarely, however, does this tax benefit outweigh the risks of taking back paper.

The well advised buyer will ask for personal guaranties from the seller's principals. The seller will also want the buyer to pledge the sale assets as collateral for the seller-financed portion of the price. This is accomplished by having the buyer grant a security interest in the sale assets and recording that security interest in the public records to put future lenders on notice that the sale assets are encumbered. A security interest is kind of like a real estate mortgage, except that it is on non-real estate assets.

7. Passing out the Bread. Distributing the sale proceeds to stockholders after an asset sale can present tax challenges. Unless the company is a pass-through entity, such as an "S" corporation or LLC, there may be double taxation. The sale proceeds would be taxable first to the corporation and then to the stockholders upon distribution, without any corresponding deduction at the corporate level. This may be a problem even with an "S" corporation, if there are so-called built-in capital gains from prior tax years. These adverse tax consequences may be mitigated to the extent sale proceeds can be paid out as tax-deductible salary or bonuses, although IRS can challenge this as excess compensation.

NOTE: This potential problem of double taxation in the sale of the business is sometimes the main reason for electing to be a pass-through when the entity is first formed, especially if the owners hope to sell the business someday.

The seller may also consult with its accountants as to how long these distributions can be deferred, thus spreading out your capital gains over time. If the seller pays out distributions over a reasonable period, they may be considered "liquidating distributions," taxable at capital gains rates. If distributions are spread out too long, they will be considered dividends to the stockholders taxable at ordinary income tax rates. Either way, such distributions are not deductible at the entity level.

The seller should consult with tax advisors, *before* the contract of sale is signed, as to the optimal method for distributing sale proceeds to stockholders. That tax advice may determine whether the seller is willing to accept a stock sale or an asset sale.

Successful acquisitions require a great deal of patience and planning. A deal may look simple on the napkin, and that's an important first step. But be prepared to confront difficult decisions as the formal contract is negotiated. If your expectations are reasonable and you are willing to compromise, the rewards can be well worth the effort.