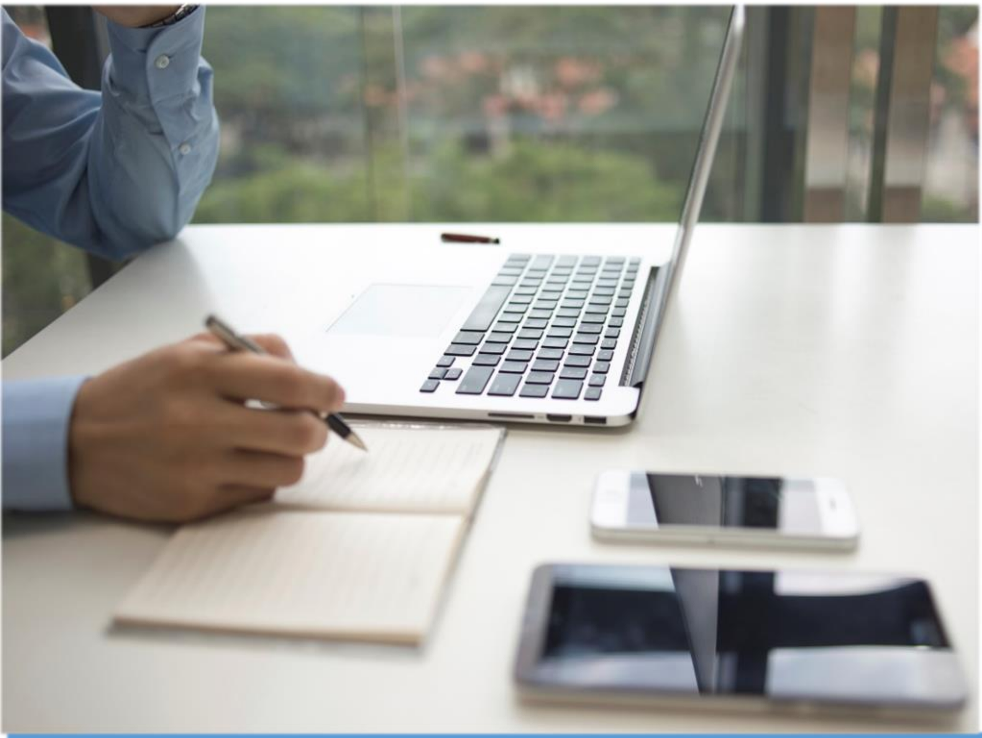

Clear Law Institute

Asset Sale vs. Stock Sale: Structuring a Business Sale Transaction with Optimal Tax Results

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Asset Sale vs. Stock Sale: Tax Considerations, Advanced Drafting & Structuring Techniques for Tax Counsel

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2

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3

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4

Outline

- Forms
- Seller's considerations
- Buyer's considerations
- Impact of the target company's characteristics
- Effect of elections under IRC § 338, § 336(e) and Treas. Reg. § 1.1502-36(d)
- International tax and state/local tax considerations
- Contractual protections

Scope

- Taxable acquisitions
  - Not qualifying as "reorganizations" under IRC § 368
- Private (or closely-held) deals
  - Target is a subsidiary or an entity held by a small or limited number of equityholders
  - Greater flexibility in structuring

Forms

Forms: Asset Sales

- Asset purchase agreement (APA)
- LLC purchase agreement (MIPSA)
  - Check-the-box rules (Treas. Reg. § 301.7701-1 et seq.)
  - Rev. Rul. 99-5 & Rev. Rul. 99-6
- Forward merger
  - See Rev. Rul. 69-6

Forms: Stock Sale

- Stock purchase agreement (SPA)
- Reverse subsidiary merger
  - See Rev. Ruls. 67-448 & 90-95

9

Seller's Considerations

10

Seller's Considerations: Asset Sale

- Income Tax Consequences
  - Ordinary income and/or capital gain (or loss) on the sale of assets
    - See, e.g., IRC §§ 1221, 1231, 1245, 1250
  - ITC recapture

Seller's Considerations: Asset Sales

- Income Tax Consequences: "Single" or "Double" Tax
  - If the Seller is an individual, entity taxable as a "pass-through" or "flow-through" (and directly owned by individuals) or under a preferential regime, proceeds generally only taxable once (at the member/shareholder level at individual rates)
    - See, e.g., subchapters K, M, S & T
  - If the Seller is taxable as a corporation for U.S. federal tax purposes:
    - Income tax imposed on the corporation (IRC § 11)
    - After-tax proceeds taxable again at the individual level upon distribution to shareholders (IRC § 301)

Seller's Considerations: Asset Sales

- Other tax considerations
  - FIRPTA
  - Real estate transfer taxes
  - Sales taxes

13

Seller's Considerations: Stock Sale

- Income Tax Consequences
  - Sellers generally will recognize capital gain or loss on the sale of target stock
    - Preferential rates may apply to non-corporate sellers with a holding period of more than one year
    - Capital losses may be subject to limitations
    - But see IRC §§ 338(h)(10), 336(e) (discussed below)
  - FIRPTA

14

Seller's Considerations: Asset Sale vs. Stock Sale

- For certain sellers, stock sale generally results in a "single" level of income tax
  - Higher threshold to application of FIRPTA to stock sale
  - However, as discussed below, depending on the target's basis in its assets, sellers may prefer an asset sale to claim a larger loss
    - See Treas. Reg. § 1.1502-36(d)
- State real estate transfer taxes & sales taxes generally inapplicable to stock sales

15

Buyer's Considerations

16

Buyer’s Considerations: Asset Sale

- Income Tax Consequences
  - Cost basis in assets
    - See IRC § 1012
  - Depending on composition of assets, step-up in tax basis can give rise to incremental increase in depreciation & amortization deductions for the buyer
    - See IRC §§ 167, 197
    - Special consideration to revised Section 168(k)
  - Purchase price allocation?
    - See IRC § 1060

17

Buyer’s Considerations: Stock Sale

- Income Tax Consequences
  - Cost basis in stock
    - See IRC § 1012
    - No cost recovery deductions with respect to stock basis
      - Stock basis available to offset future stock sale
    - But see IRC §§ 338(h)(10), 336(e) (discussed below)

18

Buyer's Considerations: Asset Sale vs. Stock Sale

- Buyers generally prefer asset sales because asset basis can be recovered currently via depreciation/amortization deductions
  - However, as discussed below, depending on the target's tax attributes, buyers may prefer a stock sale
    - But see Treas. Reg. § 1.1502-36(d)

19

Impact of Target's Tax Characteristics

20

Target Tax Characteristics

- If the buyer acquires the stock of a corporate target, the target's tax attributes generally survive subject to certain limitations
- The availability of these attributes to offset income of the target (and other income of the purchaser) after the acquisition are a critical consideration in whether a buyer may seek to structure a transaction as a stock sale or an asset sale
- Similarly, in auction contexts, sellers may anticipate an assignment of value to the target's attributes and invite the buyers to specifically allocate consideration to such tax attributes

21

Target Tax Characteristics: Examples

- Net operating losses (NOLs) & NOL carryovers
  - See IRC § 172
- Capital losses & capital loss carryovers
  - See IRC § 1212
- Business credit & foreign tax credit carryforwards
  - See IRC §§ 27, 39
- Minimum tax credits
  - See IRC § 53
- Tax basis

22

Target Tax Characteristics: Limitations in General

- The availability of tax attributes after a stock acquisition may be limited under IRC §§ 382 and 383
  - Net operating losses and net operating loss carryovers are subject to limitation under IRC § 382
  - Business credits, minimum tax credits, net capital losses and foreign tax credits are subject to limitation under IRC § 383
- In addition, if the principal purpose for which such acquisition was made is evasion or avoidance of Federal income tax, tax attributes may be subject to limitation under IRC § 269
- Further, anti-abuse doctrines developed under case law may also apply to limit a target's attributes

23

Target Tax Characteristics: IRC § 382 Limitation

- The limitation under IRC § 382 arises routinely when buyers are valuing a target's tax attributes
- As a general matter, the IRC § 382 limitation is applied to limit the amount of the target's NOLs that may be used to offset income after an ownership change
- The IRC § 382 limitation is generally computed as the equity value of the target immediately prior to the ownership change multiplied by the long-term tax-exempt rate (which is reset monthly by the IRS)
  - Subject to important complex exceptions intended to allow a target's pre-change losses to offset its pre-change income

24

Target Tax Characteristics: IRC § 382 Limitation (cont.)

- The detailed rules of IRC § 382 are among the most complex under subchapter C and are beyond the scope of this presentation; however, consider the following:
  - The application of the limitation under IRC § 382 can severely limit the value of a target's tax attributes
  - Confirmation of the proper application of IRC § 382 can be a time-consuming & expensive process for a potential acquirer
  - Performing due diligence to determine whether a target's claimed NOLs and other attributes were properly taken can be very difficult and subject to significant uncertainty
- From a seller's perspective, buyer's failure to properly compensate seller for tax attributes can amount to a windfall

25

Elections Under IRC § 338, § 336(e) and Treas. Reg. 1.1502-36(d)

26

IRC § 338(g) Election

- Referred to as a "regular" or "straight" IRC § 338 election
- Rarely made unless target has NOLs or unless target is foreign
  - Unless target is foreign, generally no consequences for seller and therefore beyond the scope of this presentation
  - In acquisition of foreign target, parties typically address buyer's ability to make an IRC § 338(g) election in transaction documents

IRC § 338(h)(10) Election

- If target is being acquired from an affiliated group (or is an "S Corp"), IRC § 338(h)(10) allows the sellers to recognize gain inherent in the underlying target assets instead of recognizing gain on the sale of target stock
  - Buyer must also be a corporation to make the election
  - Buyer's acquisition must be a "qualified stock purchase"
    - Generally, any transaction or series of transactions in which stock (meeting the requirements of IRC § 1504(a)(2)) of 1 corporation is acquired by another corporation by purchase during the 12-month acquisition period.
- In effect, election treats sale of target stock as a deemed sale of target assets to a "new" target followed by liquidation of "old" target
- Allows buyer to purchase shares but receive a "step-up" in the basis of the assets acquired

IRC § 338(h)(10) Election (cont.)

- Buyer and seller may both benefit from an IRC § 338(h)(10) election
  - Seller may be indifferent between a stock and asset sale, in which case the seller may ask for additional consideration to "share" in the tax benefits to the buyer from the election
- Alternatively, if seller is harmed by an IRC § 338(h)(10) election, seller may require a "gross-up" from buyer to be kept whole on an after-tax basis
- Filing requirements for IRC § 338(h)(10)
  - IRS Form 8023
  - IRS Form 8883

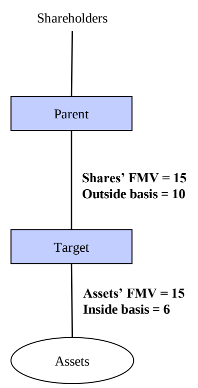
29

IRC § 338(h)(10) Election (cont.)

- Covenants concerning filing requirements for IRC § 338(h)(10) election are typically spelled out in the transaction document
  - Note that IRS Form 8023 has a deadline distinct from the parties' federal tax returns
  - Best practice: Make executed copies of IRS Form 8023 a closing deliverable
- Further, the election requires the parties to file a purchase price allocation with their tax returns
  - Therefore, transaction documents should provide a mechanism by which parties agree on the allocation and preparation of the return documentation

30

Forms Compared: Stock vs. Asset vs. 338(h)(10)



- **Stock sale** - If Buyer purchases the Target stock from the Parent for $15, Parent will have a $5 capital gain on the sale of its stock. Buyer will then own Target, and Target will have a $6 basis in its assets.
- **Asset sale** – If Buyer purchases the assets from Target for $15, Target will have a $9 taxable gain on the sale. Buyer will take a $15 cost basis in the assets.
- **Section 338(h)(10) election** – If Buyer purchases the stock of Target from the Parent for $15, and both the Seller and the Buyer make a joint election under Section 338(h)(10), the transaction will, for income tax purposes, be deemed to be a sale of assets. Buyer takes a basis in the assets equal to $15. Parent will recognize $9 of gain on its consolidated income tax return on Target's deemed sale of assets, which is greater than the gain it would have recognized on a sale of Target stock without a 338(h)(10) election ($5). Thus, Buyer may have to compensate Parent in order to make the 338(h)(10) election – the "gross up".

IRC § 336(e) Election

- Similar in function & effect to an IRC § 338(h)(10) election with a few important procedural differences:
  - Buyer need not be a corporation to make the election
  - Election available upon a qualified stock disposition, which includes certain distributions
  - Election made by seller & target, not seller & acquirer

Treas. Reg. § 1.1502-36(d) Elections

- In some ways, Treas. Reg. § 1.1502-36(d) operates as a forced IRC § 338(h)(10) in a loss scenario
- In the absence of certain elections, if a consolidated group sells a subsidiary for a loss, the acquirer may be required to reduce the target's attributes for the amount of the stock loss taken by the seller
- However, by election, the seller can forego the stock loss or reattribute certain of target's attributes (or any combination thereof) to avoid the target's "inside" attribute reduction in the buyer's hands
- In effect, the elections invite the buyer and seller to value and compensate one another for the use of the tax attributes

33

Treas. Reg. § 1.1502-36(d) Elections (cont.)

- Treas. Reg. § 1.1502-36(d) provides the parties numerous elections to tailor application of the rules of the transaction, including:
  - Seller can reduce just a portion of its loss or reattribute just a portion of its attributes (or a combination thereof)
  - To the extent the application of the rules results in a reduction of target's attributes (and less than all such attributes are so reduced), seller can determine which attributes are reduced and by how much

34

Treas. Reg. § 1.1502-36(d) Elections (cont.)

- The detailed rules of Treas. Reg. § 1.1502-36(d) are complex and beyond the scope of this presentation; however, consider the following:
  - All the elections under Treas. Reg. § 1.1502-36(d) are, by default, solely within the power of the seller; therefore, if applicable, it is critical for the buyer to address the elections in the transaction documents
  - The scope of the attributes subject to reduction is more expansive than under other provisions of the Code (e.g., IRC § 108, 382 & 383)

35

International Tax and State/Local Tax Considerations

36

State and Local Considerations

- Income taxes
  - Disconformity (e.g., IRC § 336(e))
  - Sting tax
- Real estate transfer taxes
  - Some states apply real estate transfer tax to indirect transfers or transfers of entities with substantial real estate holdings
    - E.g., New York, Connecticut, Pennsylvania, Illinois
- Property taxes
  - E.g., California Prop. 13
- Sales taxes
  - Bulk sales compliance

37

International Considerations

- Foreign target/foreign affiliates
  - Availability of Section 245A deduction
  - Application of subpart F & new GILTI regime
  - IRC § 338(g) election
- Withholding
  - FIRPTA
  - New Section 1446(f)
  - Certain contingent consideration for IP (IRC § 871(a)(1)(D))

38

Contractual Protections

Contractual Provisions: Asset Sale vs. Stock Sale

- The tax provisions in transaction documents for asset sales and stock sales can vary significantly
  - In general, if the acquisition is a "pure" asset acquisition, i.e., neither a deemed asset acquisition for income tax purposes nor the acquisition of a trade or business, the tax provisions may be relatively simple
  - By contrast, if the acquisition is a stock acquisition or is an acquisition of equity interests treated as an asset acquisition for income tax purposes, the tax provisions can be extensive

Contractual Provisions: Asset Sale

- If the acquisition is a "pure" asset acquisition:
  - In particular, the buyer may be less concerned with the seller's income tax history
    - Should address tax liens, FIRPTA withholding & pro ration of property taxes
- In addition, the agreement will generally address sales taxes compliance and payment of transfer taxes

Contractual Provisions: Asset Sale (cont.)

- If the acquisition is one of assets constituting a trade or business, the consideration must be allocated among the assets
  - Buyer not allowed a basis in the "trade or business" as a whole
    - See *Williams v. McGowan* (2d Cir. 1945)
    - Requirement codified in IRC § 1060 (setting forth rules for applicable asset acquisitions)
  - If buyer and seller agree in writing as to the allocation, such agreement is binding on both parties (unless the Secretary determines that such allocation (or fair market value) is not appropriate)
  - Parties required to file IRS Form 8594
- Transferee liability issues may also arise

Contractual Provisions: Asset Sale (cont.)

- If the acquisition is an equity acquisition treated as an asset acquisition for income tax purposes, the tax provisions may resemble a "pure" asset acquisition, an applicable asset acquisition under IRC § 1060 or a stock acquisition depending on the facts of the transaction

Contractual Provisions: Stock Sale

- If the acquisition is a stock acquisition for income tax provisions, the tax provisions can be extensive
- Unlike asset acquisitions, buyers in stock acquisitions continue to bear risks associated with the historic tax liabilities of the target (and its subsidiaries & certain former affiliates)
- As a result:
  - Significant tax diligence may be necessary
  - Tax representations may be extensive and more tailored to the transaction
  - Parties may agree to an indemnity for taxes that divides tax liability on a "your watch/our watch" basis
  - "Tax Matters" provision addresses filings, contests, refunds, etc.

Contractual Provisions: Stock Sale (cont.)

- Tax diligence
  - Generally beyond the scope of this presentation
  - Typically performed by an accounting firm or other professional firm expert in tax accounting and tax return preparation and filing

Contractual Provisions: Stock Sale (cont.)

- Tax representations
  - Extent of tax representations is a function of:
    - Facts of the transaction
    - Tax diligence performed
    - Tax indemnity provisions
    - Allocation of specifically negotiated risks
  - At a minimum, buyer typically asks for representations regarding filing of tax returns, payment of taxes, and existence/status of tax audits or other controversies

Contractual Provisions: Stock Sale (cont.)

- Tax indemnity
  - In a private deal, generally divides tax liability on a "your watch/our watch" basis
    - Requires definition of "straddle period" taxes, i.e., taxes relating to periods that do not end on the closing date but instead "straddle" the closing
    - Consider also application of "End of Day" Rule & "Next Day" Rule in Treas. Reg. § 1.1502-76(b)
  - "Pre-Closing Taxes" carefully defined
    - Consider whether certain taxes that arise after the closing more appropriately treated as "pre-closing" taxes
  - Consider whether tax indemnity should be subject to typical limitations found in the general indemnity (e.g., baskets, deductibles, caps)

Contractual Provisions: Stock Sale (cont.)

- Tax indemnity
  - Whether and to what extent the tax indemnity covers breaches of tax representations and covenants varies among agreements
    - While there may be duplication in scope, buyer should not be indemnified twice for the same loss
    - If taxes are reflected in the contract's working capital adjustments, attention should be paid to coordination between those provisions and the tax indemnity provisions
  - If the damages for breaches of tax representations are the buyer's sole source of indemnity for taxes, more attention may be paid to the scope of the representations and the items (if any) on the disclosure schedule

Contractual Provisions: Stock Sale (cont.)

- Tax Matters
  - If seller has agreed to indemnify buyer with respect to pre-closing taxes (whether by indemnification for tax representations or a "your watch/our watch" indemnity), parties will typically include additional provisions addressing return filings, payment of taxes, audits, controversies, refunds and carrybacks relating to indemnified taxes
    - Note: Federal NOL carrybacks eliminated post-TCJA
  - Depending on the target's attributes and the presence of existing or anticipated audits or controversies, these provisions can be detailed and extensive

49

Contractual Provisions: Stock & Asset Sales

- Other provisions
  - Tax treatment of purchase price adjustments
  - Tax treatment of indemnity payments
    - Consider difference in tax treatment of payments of assumed liabilities in stock and asset transactions
      - See, e.g., Rev. Rul. 76-520
  - Interim covenants
  - Buyer's ability to withhold
    - Deliver of FIRPTA certificate
  - Transfer taxes

50

Contractual Provisions: Elections

- If the parties wish to make an IRC § 338(h)(10) election, parties will want to set forth their mutual obligations in transaction documents (e.g., filing returns; allocation of purchase price)
- If buyer could make an IRC § 338(g) election that could have an impact on the seller (i.e., target is a "controlled foreign corporation" with respect to which seller is a "U.S. shareholder"), parties will want to address any right to make such an election
- If Treas. Reg. § 1.1502-36(d) could impact the target's tax attributes, the parties will want to set forth what elections the seller will make under Treas. Reg. § 1.1502-36(d) in connection with the transaction