TAX BASICS OF BUYING AND SELLING A CORPORATION

This article explores tax basics of the purchase and sale of a corporation using cash and a promissory note in two formats: a sale of the shareholder's stock and the sale of the corporation's assets. Within these areas, sc~ insights will be offered on variations of the basic format of corporate acquisitions. Of course, the tax aspects of "a transaction can't make a bad deal into a good deal one, or a shaky buyer into a strong one." The economic sense of a transaction in the intended legal documents is usually more important than the tax consequences. Tax planning, however, always makes a good deal even better.

The fundamental rule of taxation in buying and selling a corporation is simple: generally, what is good for the buyer is bad for the seller, and vice-versa. Also, the more complicated the transaction, the greater the chance for intrusion by the Internal Revenue Service.

The first method would be the seller exchanging his stock for cash, signing his shares over to the buyer of the corporation. In terms of tax, this is by far the best alternative for the seller, since he will realize capital gains on the difference between the selling price and his basis in the stock. The seller may realize an ordinary loss, if he sold the stock for less than his basis under Internal Revenue Code Section 1244.

In accordance with the fundamental rule noted earlier, a cash for stock exchange is the best alternative for the seller, and the worst alternative for the buyer. The buyer won't receive a stepped—up basis for the assets that the corporation owns even if he paid more than the book value for the company. When the seller transfers his entire stock holdings in exchange for the buyer's cash, generally there are no changes in the tax attributes of the target corporation.

The cash for stock situation is highly unlikely in reality. Usually the buyer offers the seller a small cash down payment and agrees to pay the balance on a promissory note over a period of years. In this situation the seller recognizes his gain using the installment method of reporting, unless he elects otherwise. Generally, the gain is reported in the taxable year in which the cash is received.

As the sale of stock favors the seller, the sale of assets favors the buyer. Thus, according to the fundamental rule, the tax consequences to the seller in this situation are less than favorable. The buyer doesn't want to purchase the seller' s headaches when he buys the assets from a corporation; he generally cuts off the problems associated with purchasing the stock. He receives a stepped—up basis of the acquired assets equal to the cost and can now allocate the purchase price among the acquired assets for whatever sort of terms he can arrange with his seller. The buyer can also select his own corporation capital structure, with a new year end, as well as new methods of accounting.

If the corporation makes the sale, it is taxable to the corporation. The seller would then have to pay a capital gains tax if he wants the proceeds from the sale by going through a liquidation. As a result, the seller may pay corporate as well as an individual tax. To avoid the double tax treatment the customary procedure is to negotiate the terms of the transaction, and then before the actual sale elect a complete liquidation under Section 337.

Other techniques in buying and selling are areas of forming a subsidiary corporation to be liquidated into the parent corporation. Once the election is' made, the assets of the entire corporation are treated as immediately sold and purchased by the target corporation for an amount equal to the basis of the target corporation's stock. Another method of acquisitions is for the use of a bootstrap acquisition. This method the buyer purchases a small amount of the stock from either the selling shareholder or the target corporation and then causes the corporation to redeem a large amount of the stock of the selling shareholder into its treasury. The seller realizes his full capital gain, part from the selling of the stock to the buyer and part from the complete redemption of his remaining stock.

The article attempts to touch briefly on various methods of selling and buying a corporation. There are many tax complications involved in any of these transactions and must be researched thoroughly before any decisions are made in this area. A properly structured buy and sell situation can work well for both sides of the transaction and create a deal, which otherwise may be difficult to complete.