Upcoming Events

Networking Event
March 30, 2017
4:30 PM to 7:00 PM
325 N. Washington Street
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MBBI Illinois Event
2017 M&A Market Trends
April 11, 2017, 5:00 PM to 7:00 PM
The Drake Oak Brook
Oak Brook, Illinois

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MIDWEST BUSINESS BROKERS AND INTERMEDIARIES

MBBI Newsletter March 2017

Obtaining Asset Sale Treatment on a Sale of Equity

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Contributing Editors: Andrew J. Kelleher, Vasili D. Russis and Robert A. Holland of Kelleher & Buckley, LLC. Andrew Kelleher is a co-founding member of Kelleher & Buckley, LLC, and member of the Board of Directors for MBBI's Illinois Chapter. Vasili Russis is a member at Kelleher & Buckley, LLC, and head of the firm's Tax & Wealth Structuring Practice Group. Robert Holland co-chairs the firm's Estate Planning & Administration Practice Group with an emphasis in closely held business representation.

One fundamental aspect of a middle-market M & A transaction is balancing the tax effects between the seller and buyer. From the seller's point of view, the goal is usually to maximize capital gains treatment and avoid being subject to higher ordinary income tax rates. To maximize capital gains treatment, most sellers prefer the sale of equity (i.e., stock of a corporation or units of a limited liability company ("LLC")). However, buyers generally prefer a sale of assets as they desire a "step-up" in basis of the purchased assets, which will allow them the tax benefits of expensing, depreciating and/or amortizing the value of the acquired assets (in addition to non-tax transaction goals such as avoiding the assumption of the seller's liabilities in a sale of equity). In most middle-market M & A transactions, acceptable seller and buyer tax results can be achieved when implementing an asset sale. Unfortunately, in many situations, due to business or other reasons, an asset sale is unavailable and a sale of equity must be implemented. This article is designed to review creative planning solutions so an equity sale can be treated as an asset sale for tax purposes

Why Is an Asset Sale Important? Simply put, an asset sale yields economic benefits by way of tax deductions for a buyer. For example, if a seller owns 100% of an S-Corporation and sells stock for $1M, the buyer gets no such economic benefits as it cannot depreciate or amortize any amount of the purchase price. However, on a sale of assets, the buyer has the ability to depreciate or amortize some or all of the purchase price through an allocation of that purchase price among the assets purchased. It should be noted that asset sale treatment is easy to obtain when a buyer purchases 100% of an LLC's membership interests.

However, when S-corporation seller is involved, or for situations when there is a sale of less than all an LLC's membership interests, achieving asset sale treatment when there is a sale of equity becomes tricky, and more thought needs to be given to a solution to bring about asset sale treatment (there is no asset sale treatment available when less than 80% of S-Corporation stock is sold).

Solution: *Sale of 100% of S-Corporation Stock | Utilizing a Converted LLC - Section 338(h)(10) Election.* When sellers represent the full ownership of an S-corporation and there is the need for an equity sale, a restructuring can be done to allow the sale to be treated like an asset sale.

First, the shareholders of the existing S-Corporation ("Op Co") set up a new and separate S-Corporation ("Holdco"). Next, the Op Co shareholders contribute their Op Co stock to Holdco, so now Holdco owns Op Co. After an election to treat Op Co as a Qualified Subchapter S Corporation Subsidiary, Op Co converts its status as a corporation into an LLC (now referred to as "Converted LLC"). At this point, all activities are non-events for federal income tax purposes.

CONTINUED Page 2

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Buyer then purchases all the membership interests in Converted LLC from Holdco, which can be reported as an asset sale and provides the buyer with a step-up in the basis of assets it has purchased because the restricting treats a purchase of all Converted LLC's membership interests as being a purchase of all the assets of Holdco.

A more commonly known solution when a buyer targets at least 80% of an S-Corporation's stock is to make what is referred to as a Section 338(h)(10) election. In a Section 338(h)(10)election, a buyer and seller can jointly elect to treat the transaction as an asset sale which will allow the buyer to capture the step-up in basis on the purchased assets but still maintain the legal structure of an equity sale. However, there are limitations in using this election. The buying entity will have to be a corporation in order to make the election. This forces the buying entity into a situation where it cannot use an LLC and obtain the preferred partnership tax treatment. Further, unless a more restrictive and less desirable C corporation is used, it will be difficult for the buyer to attract investors who desire a preferred return. As such, the acquisition parties need to be cognizant of all of the effects and restriction with a Section 338(h)(10) election, and why a Converted LLC maybe a better planning alternative.

Solution: *Sale of less than 100% of an LLC | 754 Election.* When less than all the membership interests of an LLC are being sold, tax elections can be used in order to obtain treatment for a buyer similar to what is found in a traditional asset sale. Such an election is made by the LLC on the tax return for the year of sale, referred to as a Section754 election. This 754 election will allow the buying entity to depreciate or amortize its pro rata share of the difference between the fair market value of the LLC's assets and the basis of those same assets over the normal depreciation and amortization lives. This election provides a tax benefit to the buying entity over time that it would not otherwise have received.

Balancing the Buyer's Goal of Asset Sale Treatment and the Seller's Goal of Capital Gains
Sellers almost always desire an equity sale to obtain capital gains treatment and avoid ordinary income. If a transaction utilizes one of the above solutions, the capital gains treatment desired by a seller will depend on the type of assets sold. The key for a seller is to have goodwill built into the purchase price, that generally being the amount of the purchase price that exceeds the fair market value of the tangible/identifiable assets being acquired. The more purchase price that can be allocated to goodwill, the greater capital gains treatment for seller. Buyers will almost always push for asset sale treatment, so a seller needs to be aware of issues involving capital gains and assets sales and the resulting tax exposure from those transactions.

This article is not intended as legal or tax advice. It is intended solely for informational and educational purposes. It must not be used for legal or tax advice, and is not intended to be used and cannot be used, to avoid any penalties that may be imposed on the taxpayer.

Andrew J. Kelleher, Vasili D. Russis and Robert A. Holland of Kelleher & Buckley, LLC. focus their practice in business sales, structuring, mergers, acquisitions and tax planning. The law firm of Kelleher & Buckley, LLC provides legal counsel to business owners and individuals in a wide range legal matters including corporate law, litigation, tax law, employment law, estate planning, estate and trust administration and real estate. Andrew Kelleher, Vasili Russis and Robert Holland can be reached at akelleher@kelleherbuckley.com vrussis@kelleherbuckley.com, and rholland@kelleherbuckley.com.

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