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Tax Strategies and Key Tax Issues in Selling a Business, Part 1

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TAX STRATEGIES AND KEY TAX ISSUES IN SELLING A BUSINESS

WILLIAM & MARY TAX CONFERENCE

November 12, 2010

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Sale of Personal Goodwill
Update on the Martin Ice Cream Case and Sale of Personal Goodwill for Capital Gain

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HOWARD v. U.S. 106 AFTR 2nd; 2010-514
Howard v. U.S., 106 AFTR 2nd, 2010-5140

- Dr. Howard sold dental practice organized as C Corp. Most of consideration allocated to sale of personal goodwill by Dr. Howard.

- Dr. Howard had employment contract with non-compete provisions with corp. at time of sale. Covenant in effect as long as Dr. Howard owned stock plus three years.

- District Court ruled that goodwill was a corporate asset and re-characterized the sale of the goodwill as a dividend to him from the corporation.
Howard v. U.S., 106 AFTR 2nd, 2010-5140

IRS made three main arguments.

1. Goodwill was a corporate asset because of employment agreement and non-compete.

2. The corporation had earned the income during the period that the dental practice was operated, 1980-2002, and as a result earned the goodwill.

3. Attributing the goodwill to Dr. Howard did not comport with the economic reality of the doctor’s relationship with the corporation.
Howard v. U.S., 106 AFTR 2nd, 2010- 5140

• Dr. Howard argued that asset sale agreement terminated the employment agreement and the non-compete. Court noted that even if that were the case, the goodwill generated from 1980 to 2002 was owned by the corporation.

• Court decided that because of the employment contract and the non-compete, the goodwill was owned by the corporation. If employee works for corporation under a contract with a non-compete provision, then corporation owns the goodwill generated by that professional’s work.

• Further, the court noted that because the corporation owned the income and paid the taxes on that income pursuant to the employment contract, Howard corporation controlled the assets.
Kennedy v. Commissioner, T C Memo 2010-206

- Sale of personal goodwill by owner of an employee benefits consulting business was taxed as ordinary income to selling shareholder even though shareholder had no employment contract or non-compete agreement with selling corporation.

- Sale of consulting business was structured as sale of personal goodwill by shareholder, consulting agreement for future services by shareholder, and sale of assets by corporation including customer lists.

- Payment for personal goodwill was calculated under a formula based on amount of future business that purchaser did with purchased clients.
Kennedy v. Commissioner, T C Memo 2010-206

IRS arguments:
• Because Kennedy did not own the customer list, he could not transfer the goodwill.
• Kennedy produced no evidence that he owned the goodwill and no evidence as to its value; no appraisal of the goodwill was offered, Kennedy did not have any contracts with clients.
• Personal goodwill should not be considered a vendible asset. Any goodwill asset would be based on Kennedys' relationship with the clients, and it had no value unless Kennedy continued to perform services to those clients.
• Kennedy could not have sold goodwill because he did not own the employee benefits consulting business. The business was owned by the corporation that employed Kennedy.
• The Substance-over-form doctrine required that the payment for personal goodwill should be considered payment for Kennedy's services, payments for his non-compete or both.

Taxpayer arguments:
• Martin Ice Cream compels the conclusion that Kennedy owned the goodwill asset and the payments that he received were to purchase that asset.
• The corporation could not own the goodwill associated with the client relationships because Kennedy did not have an employment contract or non-compete agreement with the corporation.
Kennedy v. Commissioner, T C Memo 2010-206

• The Tax Court concluded that Kennedy did not sell a goodwill property to the purchaser. The payments should be considered payments under the consulting agreement and the non-compete agreement.

• Kennedy did not meet the burden of proof in proving the ownership and value of the goodwill asset.

• The court noted that a payment to someone that provides ongoing services can be considered a payment for goodwill. A number of cases were cited relating to payments made to purchase accounting firms.

• The court decided that there was a lack of economic reality with the allocation of 75 percent of the purchase price for the business to goodwill.

• The amounts paid to Kennedy under the consulting agreement were unusually low.
Kennedy v. Commissioner, T C Memo 2010-206

- The court considered the taxpayer’s argument concerning the Martin Ice Cream case.

- The court noted that the Martin Ice Cream case was not dispositive in this case.

- The Court's decision in the Martin Ice Cream case was that a corporation was not taxable on payments made to the corporation’s controlling shareholder for his customer relationships.

- The Court did not address the issue as to how the shareholder should be taxed on the payments, because the shareholder had no issue before the Court. The Court was not asked to opine whether the payments should be treated as payments for services or payments for a capital asset.
Factors in Sustaining Sale of Personal Goodwill

- No employment contracts with non-compete provisions.
- Contractual allocation to personal goodwill should reflect the relative value of seller’s customer relationships; value should be substantiated.
- Amount allocated to consulting/employment agreements should reflect value of seller’s ongoing personal services, and value of non-compete agreement.
Earnouts – Tax Issues for Seller/T Shareholders

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Earnouts – Tax Issues for Seller/T Shareholders

• Most transactions today have some type of earnout/contingent consideration

• Some transactions have escrow arrangements

• When will T shareholders be taxable on contingent/escrowed amounts?

• Electing out of installment sales reporting
Earnouts – Tax Issues for Seller/T Shareholders

• Rules for determining when T shareholders will be taxable on contingent/escrowed amounts.
  
  – Unless T shareholders qualify for installment sale treatment, present fair market value of contingent/escrowed amounts will be taxable in year of sale

  – Sales of certain types of property do not qualify for installment sale treatment, e.g., inventory, depreciable property (to the extent of depreciation recapture) and publicly traded stock (IRC § 453(b)(2), (i), (k)(2))

  – Cash escrows present some risk of being treated as payment in the year of sale (Treas. Reg. § 15a. 453-1 (b)(3)), but substantial contingency to right to receive payment (other than passage of time) probably is sufficient to prevent current payment treatment (Rev. Rul. 77-294, predating Treas. Reg. § 15a.453-1(b)(3); Ltr. Rul. 8629038; Ltr. Rul. 8643029)
Earnouts – Tax Issues for Seller/T Shareholders

- Cash escrows (continued):
  - Documents should not describe escrowed amounts as first paid to T shareholders and then deposited into escrow.
  - Documents should provide for recourse, deferred payment obligation of P with escrow treated as owned by P and used to make payments to T shareholders if P does not make payments.
- Earnout must be payable by the purchaser, not a third party, to qualify for installment sale treatment (IRC § 453(f)(3)).
  - If a subsidiary of P is purchaser and P (instead of the subsidiary) is obligated to make earnout payments, no installment sale.
- Installment sale treatment does not apply if contingent amounts constitute equity for federal income tax purposes.
- Installment sale treatment does not apply to losses.
Earnouts – Tax Issues for Seller/T Shareholders

- Restricted stock plans for key employees
  - Many selling companies have restricted stock plans for key employees. Employees typically have taxable compensation income at time of sale of company.
  - Fair market value of earnout must be calculated and included as part of compensation income.
  - Value of earnout gives employee additional basis in stock for calculating future taxable gain upon installment sale of stock.
  - Careful planning is required to obtain tax deduction for compensation income to selling company, especially if S corporation with 338(h)(10) election.
  - If estimated earnout not paid, what is nature of deduction to key employee? Capital loss
  - Some transactions bifurcate consideration so that key employees receive all cash.
Earnouts – Tax Issues for Seller/T Shareholders

• When stated maximum selling price can be determined. 15a.453-1(c)(2)
  
  – Transaction is treated as though seller will receive maximum price; all contingencies resolved in seller’s favor. Sellers gain and installment sale calculations made under these assumptions.
  
  – If an event results in reduction of maximum amount, selling price is recomputed for remaining payments.

  – Regulations silent on point, presumably a loss can be taken when it is determined that too much gain has been reported. Loss should have same character as gain previously recognized.
Earnouts – Tax Issues for Seller/T Shareholders

- If installment sale treatment applies, how is T shareholder’s basis recovered (how much of each payment is return of capital instead of taxable gain)?
  - Under Treas. Reg. § 15a.453-1(c), basis recovery depends on whether:
    - Contingent amounts are subject to a cap, thus creating a maximum price (basis is recovered in proportion to ration of payment received to maximum price)
    - Contingent amounts are not subject to a cap but are payable over a fixed number of years (basis generally is recovered based on the number of years payments may be received, rather than the amount received)
    - If contingent amounts are not subject to a cap or a fixed number of years, basis is recovered over 15 years in equal amounts (but only in years payments are received), if the transaction constitutes a sale for federal income tax purposes
  - If there are multiple contingent payments, possibility exists that T shareholders will have a loss in year of last payment because of mismatching of relative amounts of basis and payments; loss could be nondeductible capital loss
Earnouts – Tax Issues for Seller/T Shareholders

- Earnout with fixed payment period, no maximum price. Reg. 15a.453-1(c)(3)
  - Seller’s tax basis in property sold is allocated in equal annual installments.
  - If no payment received in a tax year, the basis amount in excess of payment amount is carried forward to next tax year.
  - No loss allowed until remaining amount becomes worthless or final payment year is readied.
Earnouts – Tax Issues for Seller/T Shareholders

- Earnout with no maximum selling price non-fixed payment period. Reg 15a-453-1(c)(4)
  - Has sale occurred or are the payments more in the nature of rents or royalties?
  - If sale has occurred, basis is recovered in equal annual installments over 15 years starting in year of sale.
  - If payment in a year is $0 or less than basis amount for that year, unrecovered basis is reallocated in equal amounts to remaining years in 15 year period.
Earnouts – Tax Issues for Seller/T Shareholders

- Requesting permission to use alternative method of basis recovery. Reg 15a.453-1(c)(7)
  - Taxpayer can use alternative method for computing basis recovery if:
    - Alternate method is reasonable and
    - It is reasonable to conclude that alternative method will recover basis at a rate at least as fast as basis recovery under the regular rules.

Taxpayer must obtain a PLR from the IRS before using an alternative method of basis recovery.
Earnouts – Tax Issues for Seller/T Shareholders

• Will any part of the contingent payments be treated as interest?
  - Unless the agreement provides for P to pay stated interest at a rate at least equal to the "applicable federal rate" under IRC § 1274, generally a portion of each payment received will be taxable as interest (this assumes the T shareholders are not treated as owning the escrow fund, if any)
  - The interest portion of a payment is determined by discounting the payment by the applicable federal rate (minus any stated interest rate) from the date payment is due to the date of sale. The difference between the amount of the payment and the discounted amount is interest (Treas. Reg. §§ 1.483-4, 1.1275-4(c)(4))
Earnouts – Tax Issues for P

- How and when will earnout or escrow amounts affect P’s basis in acquired property?
  - Usually no basis for earnout obligations until payment is made (Treas. Reg. § 1.461-1(a)(1), (2))
  - Same result for escrowed amounts unless Seller/T shareholders own the escrow fund for income tax purposes
  - Depreciation/amortization over remaining lives of assets acquired; usually allocated to goodwill or other Section 197 intangibles

- Will any part of earnout or escrow payments be deductible as interest?
  - Determination of amount and timing of imputed interest/original issue discount are same as for Seller/T shareholders

- Will interest or other earnings on escrow fund be taxable to P? Need to cover treatment in sale documents.

- Will P recognize income or a reduction in basis if contingent amounts do not become payable or if escrow funds are returned to P?
Example 1: Taxable Sale of Stock with Earnout

- **Facts:** T is an S corporation. T has two shareholders; A, who founded S, and B, a key employee. A owns 80% of the T stock and B owns 20%. A's basis in her T stock is 80x, and B's basis in his T stock is 200x. P, a C corporation, purchases all the T stock for a total of 1000x in cash (800x paid to A and 200x paid to B), plus an earnout. The earnout provides for P to pay A and B, on a pro rata basis, 30% of T's average annual revenues in excess of a specified dollar amount for the first three years after closing. The entire earnout amount is to be paid 60 days after the end of the three-year period. P can offset against the earnout any indemnity claims against A and B for breaches of representations and warranties contained in the stock purchase agreement.

- **Issues:**
  - If each uses the installment method, how much basis can A and B recover against cash received at closing? See Treas. Reg. § 15a.453-1(c)(3). Assuming four tax years – A 25% or $20; B 25% or $50.
Example 1: Taxable Sale of Stock with Earnout (continued)

- What if earnout is subject to cap of 500x?
  - Cap permits maximum selling price to be determined (1000x + 500x – imputed interest)
  - Slightly more than 2/3 of basis will be recoverable against cash received at closing (Treas. Reg. § 15a.453-1(c)(2))

- What if A’s portion of the earnout, excluding interest, could exceed $5 million?
  - Does the interest charge of IRC § 453A apply to the deferred tax liability attributable to the excess over $5 million? See IRC § 453A(c)(6) (regulations to be prescribed for contingent payment sales); TAM 9853002 (interest charge applied where earnout was subject to cap over $5 million)
Example 1: Taxable Sale of Stock with Earnout (continued)

• What are the tax consequences to A and B, both having used the installment method, if no earnout amount becomes payable?
  - Capital loss for unrecovered basis in year it is determined no amount will be paid (See TAM 9853002)

• Would A or B be better off electing out of installment method, thus recovering 100% of basis in year of sale?
  - Must include fair market value of earnout in amount realized in year of sale -- what is fair market value?
Example 1: Taxable Sale of Stock with Earnout (continued)

- Assume earnout is not payable as part of purchase price for stock but instead is payable as contingent consideration under employment contracts between T and A and T and B:
  - Is earnout really compensation for services?
  - If not, no installment sale if purchaser of stock is not payer of earnout; like electing out of installment method
  - If compensation, full basis recovery in year of sale, and earnout payments will be taxable to A and B as compensation income and deductible by T
Example 2: Taxable Sale of Stock with Escrow

- Facts: The same as in Example 1, except that instead of earnout:
  - 500x of a total purchase price of 1500x is payable three years plus 60 days after closing, contingent upon same revenue formula as in Example 1. P’s obligation to pay the $500x is secured by a cash escrow.
  - The escrow also secures A’s and B’s obligations to indemnify P for breaches of their representations and warranties in the stock purchase agreement.
  - Escrow fund is invested in short-term Treasury bonds, with earnings to be held in escrow and distributed when (and to same persons as) 500x is distributed.
Example 2: Taxable Sale of Stock with Escrow (continued)

- Issues (in addition to those in Example 1):
  - Does cash escrow prevent installment sale treatment? Probably not
  - Who is taxed on escrow earnings? Need to cover in documents.
  - Does adding earnings to escrow prevent having a maximum selling price for purposes of basis recovery? Or are earnings, to the extent distributed to A and B, simply variable-stated interest?
  - Are answers to issues above different if P is required to pay interest at a stated rate regardless of amount of earnings?
Example 3: Sale of Stock with Escrow: § 338(h)(10) Election

- **Facts:** The basic facts are the same as in Example 1, except that the earnout is subject to a cap of $500x, having a present value (after discounting by the AFR) of $450x. In addition, A, B and P make an election under IRS § 338(h)(10). The election causes T, A and B to be treated as if T sold its assets and then distributed the net sales proceeds to A and B in complete liquidation. Assume further that:

  - T’s assets not eligible for installment sale treatment have a fair market value (net of all of T’s liabilities) of $1000x and a tax basis (net of all of T’s liabilities) of $800x, resulting in $200x of ordinary income
  - T’s remaining assets consist of undepreciated § 197 intangibles (e.g., customer contracts, going concern value, and goodwill) with zero basis
Example 3: Sale of Stock with Escrow: § 338(h)(10) Election (continued)

• Issues:
  – Assuming the earnout otherwise is eligible for installment sale treatment, may T, A and B use the installment method? Yes (Treas. Reg. § 1.338(h)(10)-1(d)(8); IRC §§ 453(h), 453B(h))
  – May T treat the earnout as consideration solely for the § 197 intangibles, thus permitting T not to recognize currently any gain on the sale of § 197 intangibles?
    • Probably not, even though New T (the deemed purchaser of T's assets) must allocate the deemed purchase price first to assets other than § 197 intangibles and will not obtain any basis in the § 197 intangibles until earnout payment is made (See Treas. Reg. § 1.338-6(b)-7(e) Ex. 4)
Example 3: Sale of Stock with Escrow: § 338(h)(10) Election (continued)

• Assuming T may not allocate the earnout entirely to § 197 intangibles, how much gain (including ordinary income) does T recognize?
  
  - Total amount realized is 1450x, of which approximately 69% (1000x) is cash and 31% (450x) is maximum amount of earnout (excluding interest)
  
  - 1000x, consisting of 690x cash and 310x potential earnout, is allocated to assets not qualifying for installment sale treatment -- $200 of ordinary income is recognized
  
  - 450x, consisting of 310x cash and 140x earnout, is allocated to § 197 intangibles -- 310x of capital gain is recognized
  
  - T recognizes 510x of gain (200x ordinary income and 310x capital gain)
  
  - A’s basis in her T stock is increased by 80% of 510x, or 408x, from 80x to 488x
  
  - B’s basis in his T stock is increased by 20% of 510x, or 102x, from 200x to 302x
Example 3: Sale of Stock with Escrow
§ 338(h)(10) Election (continued)

• In addition to 408x (160x ordinary income and 248x capital gain), how much more gain will A recognize in year of sale if she uses the installment sale method?
  – A realizes 1160x (80% of 1450x), consisting of 69% cash (800x) and 31% potential earnout (360x)
  – 69% of A’s stock basis of 488x, or 337x, is allocated to the 800x cash, resulting in 463x additional gain
  – A’s total recognized gain in year of sale is 871x; A’s remaining unrecovered basis is 151x
  – If § 338 election were not made, A would recognize only 751x gain in year of sale (800x cash minus 69% of 80x basis), all of which would be capital gain
Example 3: Sale of Stock with Escrow
§ 338(h)(10) Election (continued)

• How about B (in addition to his 102x share of T’s gain)?
  – B realizes 290x (20% of 1450x), consisting of 69% cash (200x) and 31% potential earnout (90x)
  – 290x is less than B’s stock basis of 302x, so installment sale method does not apply to deemed redemption of B’s stock
• Can B’s share of the potential earnout be valued at less than 90x, resulting in greater capital loss on deemed redemption of B’s stock? Presumably so, since fair market value no doubt is less than maximum payable (see Treas. Reg. § 15a. 453(d)(2)(iii))
  – If § 338 election were not made, B would recognize 62x gain in year of sale (200x cash minus 69% of 200x basis), all of which would be capital gain
Electing Out of Installment Sale Reporting

- Electing out of installment reporting generally has no impact on Buyer

- When to elect out of installment reporting:
  - Rising capital gain tax rates
  - Ability to use NOL carryforwards; expiring NOL carryforwards
  - Avoid installment sale interest charge

- Election out of installment reporting is generally irrevocable; it can be revoked only with consent of IRS.
Election Out of Installment Sale Treatment with Contingent Earnout Payments
Reg. 15a.453-1(d)(2)(iii)

- The FMV of the earnout payment must be included in the gain calculations in the year of sale.

- Generally the FMV of the earnout payment is equal to the FMV of the property sold, reduced by the FMV of any other property received by the Seller.

- In the "rare and extraordinary" case where the FMV cannot be determined, the open transaction may be used to account for the gain on the sale attributable to the earnout. (IRS NOTICE 2000-26, Q&A-11)