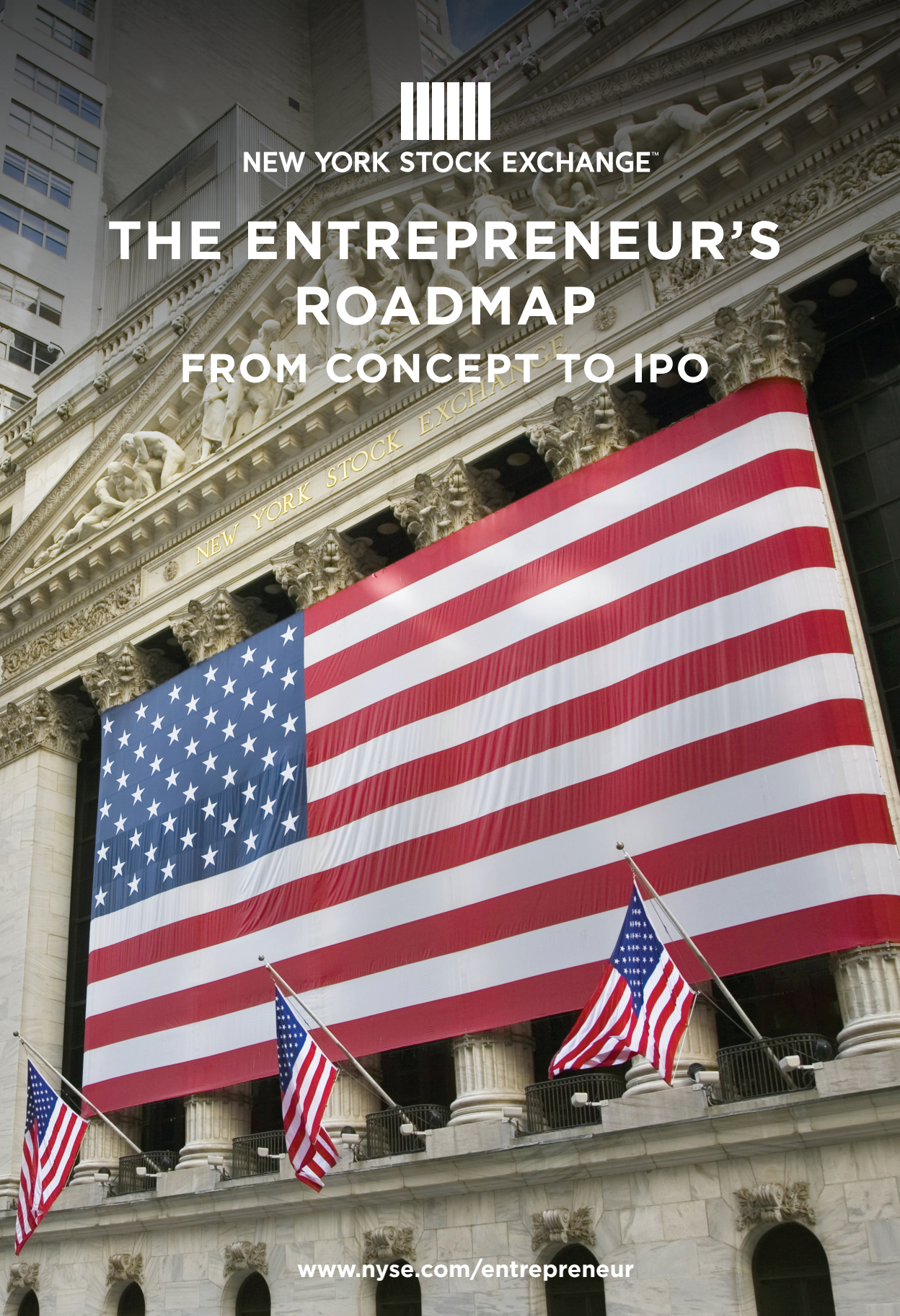
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41

EXITING THE BUSINESS: WHAT ARE THE TAX IMPLICATIONS?

KPMG

Brian Hughes, National Partner in Charge of Private Markets Group & National Venture Capital Coleader

Andrew Cherry, Tax KPMG Managing Director

You've worked long and hard to build your business. Now it's time to retire—or perhaps move onto another endeavor.

You're ready to sell the business; that much is certain. But how to do it is another matter, and it involves a host of decisions and considerations. Some are personal, some are financial. For example:

Are you able to negotiate a lump sum cash payout?

Does the buyer want to make payments that continue over time?

Are you willing to take back a promissory note from the buyer?

Do you want to stay involved in business operations (and does the buyer want you to)?

A key consideration impacting your decision that should not be overlooked is: What are the tax consequences of your exit strategy? While tax implications should not *control* what you eventually do, they should be a significant factor in how you try to structure the exit transaction. It can make a big dollars-and-cents difference in the amount of money you actually end up with.

In this section, we will be exploring the tax implications of various exit strategies.

IT'S A NEGOTIATION

What may be a favorable tax outcome for you, as a seller, may work to the tax disadvantage of the eventual purchaser (and vice versa). As a practical matter, typically there is a lot of give-and-take and intense negotiations between you and the buyer. Tradeoffs may be made on tax benefits in return for concessions on the purchase price or other deal terms.

This is one of the reasons that entrepreneurs need a tax adviser who can guide and advise them on federal, state, estate and in some cases, international, tax consequences of a sale. And, again, taxes are just one aspect of the overall transaction. There are a host of nontax considerations that must be factored in as well. In any case, selling a business is not a do-it-yourself job.

BUSINESS ENTITY DICTATES TRANSACTION STRUCTURE

The type of entity under which you operate your business will likely dictate the form of the exit transaction you would prefer.

Generally, entrepreneurs operate their businesses as a C Corporation (C Corp), a limited liability corporation (LLC) treated as a partnership, or an S Corporation (S Corp).

C Corp: If the business operates as a C Corp owned by an individual, tax considerations often dictate that the exit transaction be structured as a stock sale (as opposed to a sale of the assets of the business). When this occurs, the buyer is purchasing the owner's shares of the corporation.

LLC and S Corp: Tax considerations for an entity owned by an individual may be more flexible if the business is operated as an LLC or an S Corp. The sale transaction can be structured either as a sale of units (LLC) or stock (S Corp) *or* as a sale of the assets of the business to the purchaser with a favorable tax result. Assets can include real estate, buildings, equipment, fixtures, trade secrets, good will, inventory, receivables, and so on.

DOUBLE TAXATION FACTOR

The C Corp is subject to what's referred to as "double taxation" on earnings and, specifically, gain when it sells its assets to a buyer. That is, the C Corp initially is subject to income tax on gain upon the asset sale. Then, a noncorporate shareholder is subject to income tax when the after-tax cash is distributed by the C Corp. (However, if the C Corp has net operating losses (NOL) carry-forwards, it may offset the gain and, thereby, reduce income tax at the corporate level. Note that there may be limitations, such as those of Internal Revenue Code (IRC) Section 382 on how much gain NOLs can offset.)

However, if the transaction is structured as a straight stock sale, there is no taxation at the corporate level; only the shareholder is subject to income tax on the gain on sale of his or her shares. Thus, there is no double taxation. What's more, the proceeds are taxed at tax-favored capital gain rates (currently as low as 15 or 20 percent, depending on your tax bracket).

And if the C Corp meets certain requirements, a portion of the gain—or in some cases all of the gain—can be excluded from federal income tax under the "qualified small business stock" rules. (For example, Section 1202 of the Tax Code allows for qualified business stock treatment for C Corps that meet certain thresholds, such as not having more than $50 million in assets before and immediately after the setup date, the stock was held for at least five years, and the C Corp was an active business.)

Generally, there are no double tax consequences when dealing with pass-through entities such as an S Corp or LLC. Only the owner of the entity is subject to tax on gains. (An exception here is if the S Corp formerly was a C Corp and the sale takes place within the so-called five-year built-in gains (BIG) tax recognition period. In this case, an asset sale by the S Corp could trigger corporate-level BIG taxes (IRS Sec. 1374).)

BUYER'S PERSPECTIVE ON STOCK VERSUS ASSET SALE

Buyers generally prefer transactions to be structured as an asset sale. There are several tax as well as nontax reasons for this.

Amortization: The buyer of assets can *depreciate* or *amortize* (i.e., write off) the purchase price of the assets over a number of years. The length of time for the write-off depends on the nature of the assets purchased. However, a buyer of stock is not entitled to depreciate the cost of its stock.

For example, the purchase price is allocated to tangible assets purchased based on their fair market values. The purchase price paid in excess of the value of tangible assets (i.e., the "premium") is allocated to intangible assets, which are amortized straight-line over 15 years. The purchase price allocated tangible assets, such as machinery and equipment, is depreciated over five or seven years.

Step-up in basis: This principle allows the basis of an asset to be adjusted to its cost upon a taxable purchase. For example, say that in 2000, the seller bought a building for $1 million in which his business operates; a buyer pays $10 million for it today. The buyer will "step up" the basis of the building to its $10 million cost.

Result: If the buyer decides to sell the building, he would be subject to tax on the difference between the selling price and $10 million, not the original $1 million purchase price.

What's more, the buyer is able to claim depreciation write-offs based on the building's stepped-up $10 million basis. With a stock sale, while the buyer will take a cost basis in the acquired stock, stock is not a depreciable asset. Moreover, while the target corporation in a stock sale will be able to continue to depreciate its assets, it will not step up the basis of its assets as a result of the buyer's purchase of the target stock. If the target had already depreciated some of the assets down to zero, they can't be depreciated any further.

This inability to recover the purchase price of a business for tax purposes through depreciation deductions could create a cash-flow issue, particularly for a buyer just launching the business.

Assumption of liability: When the transaction is structured as a stock sale, the buyer is acquiring the owner's shares of a legal entity (C Corp or S Corp). This also means that the legal entity's existing and contingent liabilities (e.g., contractual, unrecorded, and otherwise) remain within the entity and are transferred to the buyer within the target, unless the parties negotiate and agree to some other arrangement. This same liability concern generally does not apply to an asset sale unless the sale is engineered as a merger. (Note that there are federal and state "successor liability" laws that may hold buyers responsible for certain liabilities, regardless of the terms negotiated between the buyer and seller.)

Tax attributes: If a buyer acquires assets in a taxable transaction, the buyer will not inherit the tax attributes (e.g., net operating losses, credits, earnings, and profits) of the selling corporation. If the buyer acquires stock, the attributes will remain in the target. However, the target's ability to use certain favorable attributes may be limited after the acquisition.

Bottom line: If you operate your business as an S Corp or LLC, then an asset sale may be most efficient from both your and the buyer's perspectives. You qualify for capital-gain treatment on the gain and there are no double-tax consequences; and the buyer receives a step-up basis on depreciable acquired assets.

Note that if the seller uses the cash-basis method of accounting for tax purposes, accounts receivable that are sold will result in ordinary income. In addition, there may be depreciation recapture on fixed assets based on how the purchase price is allocated. However, depending on the facts and circumstances, the majority of the gain should qualify for capital-gains treatment.

Also, if you sell the stock of a C Corp, the buyer won't be able to amortize its purchase price. In that case, the buyer may argue that the purchase price should be reduced based on some or all of the amount it *could* have written off had it been able to buy assets.

ACQUISITION CONSIDERATION: CASH VERSUS EQUITY

The buyer's payment, or "consideration," for your company may consist of cash, buyer debt and/or equity, or a combination of some or all of these. In any case, if a nonrecognition provision doesn't apply, the proceeds you receive are subject to tax. But how it's taxed—ordinary income, capital gains, or tax-free—and when it's taxed, depends on several factors.

Cash: Regardless of the type of business entity you're operating, if you sell stock or assets for cash, the gain is subject to income tax.

Equity: If you sell stock and you take back an equity component—in other words, an ownership interest in the buyer's business—the equity

component may be tax free or tax deferred if the transaction is structured properly.

There are a number of ways to structure a transaction so the seller won't recognize gain or loss on the receipt of equity in an acquiring corporation. For example, if you exchange the stock in your company for stock in the buyer's company and the transaction qualifies as a "corporate reorganization," it may be treated as a tax-free exchange. (This same principle may apply when an LLC is the buyer; the LLC can give back the seller "interests" in the LLC, which may be tax-free.)

This means that the seller doesn't have to pay tax on the value of the shares received on the date of sale. Rather, the tax is paid when you sell the buyer's stock at some point in the future.

However, if you receive a cash payment from the buyer in addition to the stock in a transaction otherwise qualifying as a reorganization, you are subject to tax on that portion of the proceeds.

From a tax perspective, purchasers may have less incentive to undertake a reorganization transaction compared to a taxable transaction because they generally will not adjust the basis of their assets to cost. On the other hand, the acquiring entity in a reorganization may be able to preserve certain tax attributes of the target (albeit potentially subject to limitation) that otherwise would not be acquired in a taxable transaction.

The rules that address nonrecognition transactions are complex and should be undertaken with care, as failure to satisfy their requirements potentially could subject a seller to both a corporate and a selling shareholder tax.

Taking a risk: When you take back the buyer's stock, you run the risk of the stock declining in value or the business going under. So, while your potential gain is tax deferred, if the value of the business and its stock goes down (or becomes worthless), you may wind up with little or nothing of value.

In some cases, the buyer may want or require a seller to stay on as an employee and offer him an equity interest in the company. Giving the seller "skin in the game" provides an incentive for him to continue performing well and maintaining or enhancing the value of the company.

The nature of the consideration—cash versus equity—is another one of the negotiating points between a buyer and seller and may be reflected in the ultimate sales price and terms.

ALLOCATING PURCHASE PRICE TO ASSETS PURCHASED

This is often a major point of negotiation when the exit is structured as an asset sale. The seller and the buyer have to agree on the allocation of the sales price among the various assets. This allocation can determine whether gain recognized by the seller is ordinary income or capital gain income. And with current capital gains tax rates of 15 to 20 percent, compared to the top ordinary income tax rate of 39 percent, this can make a significant bottom line difference.

It also impacts the amount and timing of the depreciation and amortization the buyer may be entitled to take. For example, a buyer typically prefers to have the purchase price allocated to fixed tangible assets (such as property, plant, and equipment) because it allows for a faster write-off period (between five and seven years). Conversely, a buyer generally would want less of the purchase price allocated to intangible property, such as goodwill, going concern value, or trademarks, which has a longer write-off period (i.e., 15 years). Depreciation of certain assets may result in ordinary income tax treatment on the portion of the proceeds allocated to those assets. The IRS and the courts generally will respect a buyer and seller's allocation agreement if it's reasonable and negotiated at arm's length.

Cash basis business: There is less room for negotiation on the allocation of unrecognized accounts receivable for a seller of a cash-basis business. These receivables must be valued at their fair market value (FMV) and are subject to ordinary income tax.

DEFERRED PURCHASE PRICE

There are several ways to arrange for deferred payment of the purchase price, and each one carries different tax consequences for both the buyer and the seller. In general, if structured properly, deferred payments allow you to recognize taxable gain only as payments from the buyer are received. Depending on your overall tax situation, this might make sense. And from the buyer's perspective, it may allow for a better cash flow, particularly in the early stages of the new business.

There also are nontax reasons for certain payment deferral arrangements, particularly from the buyer's point of view. First, a portion of the purchase price may be put into escrow (e.g., held by an attorney or third-party custodian) or otherwise held back for an agreed-upon period of time. This may be done to protect the buyer from a seller's breach of representation or warranties or if certain financial metrics are not met. (Note that with a contingent purchase price or escrow arrangement, the IRS may impute an interest rate (if one is not stated in the agreement) and require the seller to pay ordinary income on the interest portion of the deferred purchase price; see IRC Code Sec. 7872.)

Second, the parties may negotiate a contingent purchase price that will be paid only if the seller's business meets certain financial milestones after the acquisition. This arrangement often is used if the parties are unable to agree on a value of the business at the time of sale (e.g., if the business is subject to significant subsequent contingencies, such as government approval of a key product). This is also considered a form of installment sale.

Installment sales: Many sellers help finance the sale of their business by taking back a promissory note from the buyer as part of the purchase price. For example, your buyer pays you $5 million in cash on the date of the sale and gives you a note promising payment of $5 million a year for the next five years. This installment sale arrangement allows you to pay tax on your gain over a five-year period, which could be advantageous if tax rates (and your income) go down. However, if the deferred amount *exceeds $5 million*, you may have to pay the IRS interest on the deferred tax liability on the amount above that $5 million. (See IRC Code Sec. 453.)

From a nontax perspective, as with any arrangement where you don't receive full payment at closing, there's the risk of partial payment or nonpayment if the buyer and/or the buyer's business run into financial difficulties.

Contingent payments: There are times when a seller and buyer structure the exit transaction to include contingent payments with no maximum stated purchase price. An example of this type of arrangement is when the buyer agrees to pay you a stated percentage of revenue annually from the acquired business or based on some other period of time. Note that if there's no end date for payments, you may be jeopardizing your ability to accelerate the recovery of your basis. So, for these types of contingent payment arrangements, you should consider including a maximum term for the payments so you can start recovering your basis from day one.

STOCK OPTIONS AND RESTRICTED STOCK

Your company may have granted stock options or given restricted stock to employees as a reward or as a performance incentive. What happens to these instruments when you sell your company, and what are the tax implications?

As a rule, the terms of the stock option or restricted stock agreement dictate what can or must happen. In some cases, your obligations can be assumed by the buyer and replaced by the buyer with buyer's stock options or restricted stock, typically with similar terms. In most cases, however, employees prefer to cash out. After all, one of the reasons they were granted the stock or stock options was to allow them to share in the company's success in the event the business was sold or if there were a change in control.

With the cash-out option and unvested restricted stock, you generally get a tax deduction for these payments. And the value of the restricted

stock or stock options gets reported as wages on the employees' Form W-2s. These amounts are also subject to income and employment withholding (e.g., Social Security, unemployment, FICA) taxes.

FINAL THOUGHTS

At the end of the day, the manner in which you have set up your company goes a long way in dictating the structure of the sale transaction when you exit the business. For example, a C Corp generally has a strong incentive to push for selling its stock rather than its assets. There is more flexibility when the target is an S Corp, LLC, or other pass-through entity.

The parties may achieve a more favorable tax result if the seller is an S Corp, LLC, or other pass-through entity, and the buyer wants to purchase the assets of the business. Then, as with most business matters, everything else is a negotiation and almost everything is negotiable.

While the owners of a C Corp benefit from a stock sale, the buyer might not. In that case, the buyer might negotiate for a lower purchase price based on the present value of tax benefits it would have gained if the transaction were structured as an asset sale.

A seller may agree to take equity as a form of consideration from a buyer but may negotiate for a higher purchase price than if it were a straight cash deal and must be cognizant of the tax-free transaction rules. The same give-and-take can apply with respect to allocation of the purchase price among assets or deferred purchase price arrangements.

These are all factors that you and your adviser should consider when planning for and negotiating the sale of your business.

KPMG
345 Park Avenue
New York, New York 10154
Tel: +1 212 758 9700
Web: www.kpmg.com

BRIAN HUGHES
National Partner in Charge of Private Markets & National Venture Capital Co-Leader
Email: bfhughes@kpmg.com

Brian Hughes is the National Partner in Charge of Private Markets Group & National Venture Capital Co-Leader. He is a member of the American Institute of Certified Public Accountants and Pennsylvania Institute of Certified Public Accountants and sits on the Board of Directors of the Philadelphia Alliance for Capital and Technology and the Board of Directors of the New Jersey Technology Council. Brian has over 30 years of diversified experience in public accounting, and his career has been focused primarily on public and nonpublic technology, software, business services, venture capital, private equity funds, and portfolio companies. Brian has significant experience with initial public offerings, as well as acquisitions and divestitures. In addition, he has considerable experience with the international operations of U.S.-based companies, as well as the U.S. operations of foreign-based multinational corporations. Brian's client experience includes working with high-growth companies in the development stage, through subsequent rounds of financings and other capital formation transactions, or to an initial public offering or acquisition by a larger market participant.

ANDREW CHERRY
Managing Director
Email: acherry@kpmg.com

Andy Cherry is a Managing Director in the Tax practice of KPMG's Philadelphia office. He is a member of the American Institute of Certified Public Accountants and Pennsylvania Institute of Certified Public Accountants and sits on the Board of Directors of the Philadelphia Alliance for Capital and Technology and the Board of Directors of The Enterprise Center. Andy's client experience includes early-, middle-, and late-stage growth companies that are backed with private equity and venture capital and middle-market public and private companies. His experience includes advising clients on transactional tax planning for matters involving a broad range of corporate and partnership/limited liability company issues. Andy also assists his clients with their day-to-day federal income tax matters, which include tax compliance, general corporate tax planning, tax accounting methods, and the tax aspects of merger and acquisition transactions, and he represents clients before the Internal Revenue Service at the examination and appeals level.