Deal or no deal?

How to avoid taxes and consummate acquisitions **Interviewed by Leslie Stevens-Huffman**

Acquisitions can be good for business. They provide buyers with immediate revenue growth, new markets and intellectual capital while sellers have the opportunity to be financially rewarded for their efforts. But the deal's attractiveness can quickly wane when the transaction results in a double layer of taxes for the seller or a lack of step-up in basis for the buyer. Advance planning along with knowledge of the tax implications and possible alternatives are the best ways to make acquisitions advantageous for both parties.

"In some cases, there will be no immediate taxes generated by a tax-free stock exchange or only a capital gains rate may apply, and in other cases, you could be looking at double taxation under an asset sale," says Gary Curtis, corporate tax partner for Haskell & White LLP. "Since the transaction often puts buyers and sellers at odds, it's important to have enough time to look at all the alternatives and structure the deal in a way that's best for everyone."

Smart Business spoke with Curtis about how to avoid excessive taxation from acquisition transactions.

What determines the tax liabilities in an acquisition?

Usually buyers and sellers benefit from different acquisition transaction structures. In a taxable acquisition transaction, two of the influencing factors include:

- Whether the buyer is purchasing assets versus stock
- The entity structure of the seller

Sellers usually want a stock sale because the gain will be taxed only once at the relatively low capital gains tax rate. Buyers usually prefer an asset sale because they can purchase known assets and liabilities, as opposed to a stock transaction where they take on liabilities for all previous actions of the company, and the 'step-up' in basis to fair market value can be depreciated or amortized, which improves cash flow. Generally, the seller offers more warranties and guarantees to offset the unknown liabilities resulting from a stock sale, but they may get a lower sale price, as well.

Gary Curtis
Corporate tax partner
Haskell & White LLP

How does the seller's legal entity impact taxation?

If the selling company is set up as a C corporation, the principals may be hit by two rounds of taxation during an asset sale: income tax at the corporate level and again at the shareholder level when the proceeds of the sale are distributed. You can avoid double taxation resulting from an asset sale if the selling firm is structured as an S corporation. An S corporation or a business set up as a pass-through entity, such as a limited liability company (LLC), will generally only pay one level of tax, which will be at the capital gains rate. There may be some taxes at ordinary income rates, but these amounts are often insignificant in relation to the overall taxes.

What are the tax alternatives?

S corporations and LLC legal structures produce the least amount of tax liability during acquisition events. So if your company is currently structured as a C corporation, and you plan to keep the company for 10 years or longer before selling it, consider converting to an S corporation status.

A tax-free merger is another alternative. It occurs when one company acquires a controlling interest in the other company in exchange for its stock. The sellers don't report taxable gain until the new stock is sold. This method is advantageous if the shareholders of the acquired company don't want to cash out in the near future, but even if the seller wants to receive some cash from the transaction, the merger will still work as long as the seller doesn't require more than 50 percent of the sale price in cash.

Is a 338 election a viable tax alternative?

Section 338 allows the purchasing corporation to buy the stock of another company and treat the purchase as an asset acquisition under a set of specific conditions. On the surface this sounds favorable, but there are still a few things to consider. While the transaction may not result in double taxation, the seller may still be liable for some additional taxes. While an entity change may be a solution when time allows, there are other potential alternatives to the tax implications resulting from acquisitions. Each situation requires its own unique solution that will work best for both parties. <<

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