VERITAS CORPORATE LAW

Legal Update

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Veritas Corporate Law

# Selling the C Corporation: Asset Sales Can Look Better Than They Are

Many growth companies are operated as C corporations, and frequently that's a sensible thing to do. The familiar shareholder/board/management structure of a corporation can be more comfortable for the participants than the more amorphous and flexible LLC structure; the shareholders are not bothered with K-1s and pass-through tax outcomes (the absence of which is an essential requirement for some types of institutional investors); and, because its tax incidences do not flow through to its equity owners, the C corporation's financial details need not be disclosed to them to the same degree and with the same frequency as those of an LLC or S corporation.

However, there is a major drawback to C corporation ownership that sometimes is not discovered until it's too late to fix. A C corporation is taxed on its operating revenues, and its shareholders must also pay tax on any distributions or dividends they receive from it—the dreaded double tax. While many owner-managed small corporations can avoid the double tax by paying out profits as compensation to their managers, there are limits to that approach, such as restrictions on excessive compensation and the difficulty of matching owners' service compensation with their share ownership percentages. But a much bigger tax problem can arise if the C corporation decides to sell its appreciated assets: The tax bite can be stunning.

An example will illustrate.

You own and operate a packaged goods business through a C corporation. Your business has been growing robustly for a few years, and has invested heavily in capital equipment and inventory in anticipation of greater sales. You've grown the company from $10M to $20M in revenues in just two years.

You decide that the company's recent growth makes this a good time to sell. You talk to five or six plausible bidders, and you receive two offers. One is an offer to acquire the enterprise for $65M through a merger. The other is an offer to purchase the assets at a very flattering price—$100M—5X revenues and 10X the cost basis of your assets!

You quickly enter into a nonbinding letter of intent (LOI) with the $100M bidder, with a typical, binding 90-day no shop clause prohibiting discussions with other potential bidders, then call your lawyer to get the purchase agreement completed as soon as possible.

## The Purchase Price Can Be Deceptive.

Your lawyer, Christa Corporate, tells you that the $100M asset deal may not be as good as it looks. First, she points out that an asset purchase means that all assets (including accounts receivable) are transferred to the buyer unless otherwise agreed, but all debts and other liabilities remain with the seller unless they are expressly assumed. Because of your rapid expansion, you have a $10M fully drawn line of credit and $5M in trade payables and other current liabilities. Because the accounts receivable are transferred, you will need to pay the liabilities out of the proceeds of the deal, so the $100M offer is really an $85M offer. Still, you say to yourself, that's better than a $65M offer for the whole enterprise.

## Taxes Can Take a Big Bite Out of Proceeds.

Corporate Tax. But next, Christa conferences in her partner, Tom Tax. Tom tells you that the aggregate tax hit of the seller and its investors from an asset sale by a C corporation is often significantly greater than the tax hit of a merger or sale of shares. He points out that if the basis of the assets is $10M, and they are being sold for $100M, there is a $90M item of taxable income to the Company, before it distributes any proceeds to the shareholders or pays off any debt. The $90M would be taxed as ordinary income on the amount paid for inventory and accounts receivable, and taxed as capital gain to the extent the items sold were capital in nature, such as plant and equipment. Tom says it's reasonable to assume a combined state and federal corporate tax rate of 41%. One bright spot is that the $5M payment of trade payables is deductible, making the total income $85M (but sadly, the $10M repayment of principal on debt is not). After a few quick calculations, he determines that the after-tax amount distributable to shareholders is $100M minus $15M for payment of liabilities, minus $35M for payment of corporate level income and capital gain tax ($85M x 41%), or $50M. You say, well, that's not a horrible result. But Tom then tells you there's more.

Shareholder Tax. Tom asks how much was paid for the stock when it was bought, and you are proud to point out that you started the company from scratch just a few years ago and the equity investment was only around $100K. You can almost see Tom frowning at the other end of the phone as he says there's going to be some serious tax payable by the shareholders. Since they have only $100K in basis, if they receive a distribution of $50M they will be taxed on almost all of it, as long-term capital gain (since they had all held their shares for several years). The rate will be between 15% and 23.8% depending on their income level—he assumes around $9M at a blended rate of 18%. So your $100M deal is going to yield shareholders about $41M after payment of liabilities and corporate and individual tax.

## Lower Priced Offers Structured Differently May Be Better.

Feeling a little stunned and embarrassed, you then mention that you also received an offer to merge the company into the buyer for $65M. You hear calculators clicking on the other end of the line. Christa notes that the merger would transfer all assets and liabilities to the buyer, meaning there is no implicit reduction of the purchase price to pay liabilities. Tom then explains that if you had taken that offer, the tax would be at the shareholder level only and would all be treated as long-term capital gain. Assuming the same blended rate of 18%, the tax would be @$11.7M, and the net after-tax proceeds to shareholders would be $53.3M, or about $11.3M better than the $100M asset deal.

You quickly note that the LOI for the $100M deal is nonbinding, but Christa points out that it has a binding no-shop clause, preventing you from talking to any other bidder for 90 days, by which time your other bidder may have lost interest or found another company to buy.

It's then that you realize that a twenty-minute phone call with your lawyers could have yielded $11M, an additional @20% of after-tax proceeds!

## Avoid a Tax Mess When Selling Your Business.

Follow these tips to limit tax consequences in selling a business:

1. Consider operating a tax pass-through business (an S corporation, limited liability company or partnership) rather than a C corporation. While doing so may require more transparency with investors regarding the company's financial performance, and may limit the company's attractiveness to certain types of investors such as venture capitalists, it can provide a much better opportunity to keep taxes modest in connection with a sale. If the company is likely to be seeking an exit in the foreseeable future, and can be funded and operated with a tax pass-through structure, there could be very valuable advantages at the time of sale.
2. Consider offering to sell your company stock to the buyer or merge your company with the buyer (or a buyer subsidiary), rather than selling the business assets. This may be impractical, as many buyers feel it is their prerogative to structure the offer as they prefer, and they very often prefer asset sales. A purchase of assets allows them to leave behind the corporate structure and liabilities of the seller and to step up the basis in the assets to the purchase price, which normally generates more and faster depreciation deductions to the buyer than does a merger or stock purchase.
3. If the asset-sale structure is unavoidable, negotiate to retain cash and accounts receivable to offset trade payables and possibly other outstanding liabilities. Also, make efforts to negotiate the allocation of purchase price toward those assets that generate capital gain rather than ordinary income.
4. Consider whether any of the value of the transaction can be assigned to personal goodwill of the owner/operators rather than to the entity's assets. The names, identities or reputations of the owners, or their intellectual property or other assets used in the business but not transferred to it, can justify a separate purchase of those assets from their owners. Care must be taken to avoid unfairly reducing payments to other shareholders, but a factually justified payment to the owner/operators can result in capital gain for them, rather than double-taxed income through the selling company.
5. Most importantly, consult with experienced tax and corporate counsel before agreeing (even in principle) on deal structure. Don't sign a term sheet, letter of intent or memorandum of understanding, even if it purports to be non-binding, or a no-shop agreement, until counsel has had a chance to look at it, evaluate the legal and tax impact on your company and its owners, and evaluate alternative structures. Once such a document is signed, the buyer will normally become quite resistant to substantive deviations from it. The relatively brief and cost-efficient involvement of counsel at this strategic stage can result in the most significant benefit you will realize from your counsel—shifting or reducing the tax burden significantly.

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