Tax Considerations in Buying or Selling a Business

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March 2014

I. CONSEQUENCES GENERALLY

The after-tax consequences of buying or selling a business can vary significantly depending on the tax classification of the entity conducting the business (referred to in this outline as the "Company") and on how the sale is structured. Often, what is good for one party to the sale is bad for the other. The structure of the sale, therefore, is often driven by the relative bargaining positions of the parties and, in any event, may affect the price paid by the purchaser.

a. Corporation.

1. **Stock sale.** If the Company is a corporation, its shareholders will generally prefer to structure the transaction as a purchase and sale of their stock (rather than as a purchase and sale of the Company's assets).[1] That way, the gain on the transaction is taxed only once (at the shareholder level) and is capital gain (long-term in the case of any shareholder who has held his or her shares for more than a year).[2] Any losses recognized by the shareholders generally are capital losses (except to the extent they can be treated as ordinary losses under Code Section 1244).[3] The purchaser, on the other hand, may not want to purchase stock because, except as described in I.a.3. below ("Stock sale treated as asset sale"), a stock purchase has no effect on the tax bases of the Company's assets. Instead, the purchaser takes a basis in the stock purchased equal to the amount it pays for the stock, and the taxable income inherent in the Company's assets remains inherent in the assets. Stock is not amortizable.

1 Even from a non-tax standpoint, the shareholders may prefer a stock sale because the purchaser assumes the economic burden of any Company liabilities subject to any continuing obligations of the shareholders to indemnify the purchaser for breaches of representations and warranties under the purchase agreement. A stock sale might also be desirable, for all parties, if the Company has assets (such as contract rights, licenses or permits) that may be difficult to transfer.

2 If the stock in the Company is "qualified small business stock" under Internal Revenue Code ("Code") Section 1202, individual Company shareholders who have held their shares for more than five years may be able to exclude portions of their gains under Section 1202 (or, if they have held their shares for more than six months, roll their gains into newly acquired "qualified small business stock" under Code Section 1045). If the Company is an S corporation, stock in the Company cannot be "qualified small business stock," and, if the S corporation owns "collectibles," a portion of the shareholders' gains may be taxable at a higher capital gain rate than would otherwise apply.

3 Section 1244 permits individuals to report up to $50,000 ($100,000 in the case of a husband and wife filing a joint return) of their losses for any year from sales or exchanges of "section 1244 stock" as ordinary losses. "Section 1244 stock" is stock issued for money or other property by a "small business corporation" (the corporation may not have received more than $1,000,000 in money or other property for stock) that satisfies an active gross receipts test.

A. Form of stock sale. A stock sale may be affected by a direct purchase and sale of the stock in the Company or by a "reverse subsidiary merger."[4] In a reverse subsidiary merger, the purchaser forms a transitory subsidiary, capitalizes the transitory subsidiary with the purchase price (which may include borrowed money if the purchase will be leveraged), and then merges the transitory subsidiary into the Company. When the dust settles, the selling shareholders have the purchase price, and the Company is owned by the purchaser.

2. Asset sale. At least from a tax standpoint, if the Company is a corporation, the purchaser will generally prefer to structure the transaction as a purchase and sale of the Company's assets (rather than as a purchase and sale of the stock in the Company).[5] That way, the purchaser can "write up" the tax bases of the Company's assets and thereby report greater depreciation and amortization deductions with respect to, and smaller amounts of gain (or greater amounts of loss subject to any applicable limitations) on re-sales of, the purchased assets. The Company's shareholders, on the other hand, may not want to structure the transaction as an asset sale because (i) if the Company is a C corporation, the gain will be subject to tax at both the Company and shareholder levels, or (ii) if the Company is an S corporation, some or all of the gain may be reportable by the shareholders as ordinary income depending on the Company's assets and the allocation of the purchase price (and, if the Company holds assets with built-in gain subject to tax under Code Section 1374, the built-in gain will be subject to tax at both the Company and shareholder levels, with a deduction for the shareholders of the tax payable by the Company).

A. Form of asset sale. An asset sale may be affected by a direct purchase and sale of the Company's assets or by a merger of the Company into the purchaser or a subsidiary of the purchaser.[6]

B. Purchase price allocation. In an asset sale, the Company is treated as selling, and the purchaser is treated as buying, the various Company assets separately for allocable portions of the aggregate purchase price. The aggregate purchase price is allocated among the various Company assets by class and fair market value under rules set forth in regulations under Code Sections 1060 and 338.[7] Particularly if the Company is an S corporation, the Company's shareholders will prefer to allocate the purchase price so as to maximize the amount of long-term capital gain to be reported by them on the sale. The purchaser, on the other hand, will likely want to allocate as much purchase price as possible to assets that are likely to turn over in the short term or that have short depreciation or amortization schedules.

3. Stock sale treated as asset sale. If the Company is an S corporation (or a subsidiary member of a group of corporations filing a consolidated return) and its shareholders sell at least 80% (by vote and value) of the outstanding stock in the Company (in a single transaction or a series of transactions within a period of twelve months), the sale may be treated for tax purposes as a sale of the Company's assets by means of an election under

4 See Rev. Rul. 73-427, 1973-2 CB 301 and Rev. Rul. 78-250, 1978-1 CB 83. If the transitory subsidiary incurs debt that is assumed by the Company in the merger, shares purchased with the borrowing proceeds are treated as having been redeemed by the Company. Any shares so redeemed from a Company shareholder are treated as having been sold by the shareholder if the redemption, in conjunction with any sale of other shares by the shareholder in the merger, satisfies one of the Code Section 302(b) tests. From a corporate law standpoint, the reverse subsidiary merger generally allows for the purchase of all of the stock in the Company without the approval of all of the Company's shareholders. Generally, though, dissenting shareholders have "appraisal" rights entitling them to receive a judicially determined fair price (which can be addressed with "drag-along" provisions of agreements among the Company's Shareholders).

5 From a non-tax standpoint, the purchaser may prefer an asset purchase as well so that the economic burden of the Company's liabilities remains with the Company and, in effect therefore, the Company's shareholders.

6 See Rev. Rul. 69-6, 1969-1 CB 104. In an asset sale effected by a merger of the Company into the purchaser (or a subsidiary of the purchaser), the purchaser (or subsidiary of the purchaser) assumes any tax liabilities of the Company (including any tax liability resulting from the merger) by operation of law.

7 Those regulations establish seven classes of assets. The first two classes consist of cash, cash equivalents, actively traded personal property, certificates of deposit and foreign currency. The third class consists of accounts receivable, mortgages and credit card receivables arising in the ordinary course of seller's trade or business. The fourth class consists of inventory or property held primarily for sale to customers in the ordinary course of the seller's trade or business. The fifth class consists of all assets not in any of the other classes (such as machinery, equipment and real estate). The sixth class consists of Section 197 intangibles other than goodwill and going concern value. The seventh class consists of goodwill and going concern value. In general, purchase price is allocated sequentially by class to the extent of the fair market value of the assets of the class.

Code Section 338(h)(10) or Code Section 336(e).[8] Such an election is generally made by mutual agreement of the parties (if the Company is an S corporation, however, all of its shareholders must consent to the election). If such an election is made, the Company's shareholders determine their tax consequences as if the Company had (i) sold its assets for the amount paid for the Company stock in the qualifying sale or sales (grossed up if less than all of the outstanding stock in the Company has been sold in such qualifying sale or sales) plus the amount of the Company's liabilities and then (ii) liquidated, distributing its assets (the proceeds of its deemed asset sale) to the shareholders.[9] The purchaser, on the other hand, is deemed to acquire a "new" Company with stepped-up asset bases. The election may be disadvantageous to the Company's shareholders for the reasons noted under "Asset sale" above (possibility of ordinary income and, if the Company holds assets with built-in gain subject to tax under Code Section 1374, double-taxation).[10] In addition, if less than all of the outstanding stock in the Company is sold, the Company is nonetheless treated as having sold all of its assets (triggering all of the gain inherent in its assets).[11]

4. Reorganization. If the Company and the purchaser are corporations, the transaction may be "tax-free" entirely or in part to the Company's shareholders if it qualifies as a "reorganization" under Code Section 368.[12] In that case, the Company's shareholders generally recognize their realized gains under Code Sections 354 and 356 only to the extent of any of their purchase price that is paid in cash or in property other than qualifying stock of the purchaser (or the purchaser's parent corporation).[13] Any realized gain they avoid recognizing remains inherent in the qualifying purchaser (or purchaser parent) stock they receive in the transaction.[14] The purchaser writes up the tax bases of the Company's assets under Code Section 362(b) only to the extent of any gain recognized by the Company.[15]

b. Partnership.[16]

1. Equity interest sale. If the Company is a partnership for tax purposes and the Company's owners sell their equity interests in the Company to the purchaser, the Company's owners are required to report,

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8 For a Section 338(h)(10) election to be made, there must be a single purchaser and that purchaser must be a corporation. In either case, stock acquired in a transaction to which Section 351 of the Code (or any of certain other non-recognition provisions) applies does not count toward satisfying the 80% threshold. In addition, if holders of 50% or more of the Company's stock before the purchase own 50% or more of the stock of the purchaser after the purchase, the purchase may be treated as a Section 304 transaction.

9 See Regulations Section 1.338(h)(10)-1. Thus, the Company's shareholders do not report separate gains or losses on the sales of their shares.

10 The election may also be disadvantageous to the Company's shareholders if their stock bases are greater than the Company's asset bases.

11 A more palatable alternative to a purchase of less than all of the outstanding stock with a Section 338(h)(10) or Section 336(e) election may be to have the Company transfer its assets to a corporation or limited liability company ("LLC") for cash and a minority equity interest in the corporation or LLC (with the purchaser owning the majority of the equity in the corporation or LLC) in a transaction to which Section 351 or Section 721 applies, as the case may be. The consequences to the Company may vary depending on whether the transferee is a corporation or LLC because of differences in the rules that apply to contributions to corporations, on the one hand, or partnerships, on the other, for qualifying equity and property other than non-qualifying equity (such property is sometimes referred to as "boot"). Another alternative is for the Company to contribute some of its assets to a partnership for minority interest in the partnership and sell its remaining assets to a corporation controlled by the partnership, with the partnership contributing the assets it receives from the Company to the partnership.

12 There are a limited number of ways for a transaction to qualify as a reorganization. A detailed discussion of those ways is beyond the scope of this outline. Each way, however, requires (among other things) that a minimum percentage of the price paid for the Company be paid in the form of qualifying stock of the purchaser (or its parent). The minimum percentage ranges from 40% for a straight (i.e., not a reverse subsidiary) merger (an "A" reorganization) to 100% for a simple stock-for-stock swap (a "B" reorganization). Sections 351 and 721 can also provide "tax free" treatment entirely or in part if the transaction involves the contribution of stock or assets of the Company to a corporation or partnership for equity.

13 This cash or other property, like cash and other non-qualifying property received in a Section 351 or Section 721 transaction, is also sometimes referred to as "boot."

14 If the Company stock is "qualified small business stock" under Code Section 1202, the stock of the purchaser (or its parent) received by a Company shareholder in the reorganization is also treated, under Section 1202(h)(4), as qualified small business stock (if it otherwise would not have been) received by the Company shareholder on the date he or she acquired his or her Company stock. The amount of gain that may be treated as gain from the sale of qualified small business stock upon the subsequent sale of the stock of the purchaser (or its parent) by the Company shareholder, however, is limited to the amount of gain built into the Company stock as of the time of the exchange of the Company stock for the purchaser (or purchaser parent) stock.

15 Because any gain in a reorganization on account of boot is usually reported by the Company's shareholders rather than by the Company, the purchaser generally gets no basis increase in the Company's assets.

16 Entities classified as partnerships for tax purposes include LLCs, limited partnerships, limited liability partnerships and general partnerships (so long, in each case, as they have more than one owner and have not elected to be classified as corporations).

under Code Section 751(a), the ordinary income they would have had to report if the Company had sold any "unrealized receivables" (which include, among other things, depreciation recapture inherent in any depreciable property) or "inventory" (which includes, in addition to traditional inventory, property income from the sale of which would be ordinary) it may have at fair market value. Any remaining gain or loss a selling owner of the Company may have on the sale is generally capital gain or loss under Code Section 741.[17] The purchaser, on the other hand, is treated as having purchased the Company's assets if the purchaser purchases all of the outstanding interests in the Company.[18] Alternatively, if the purchaser does not purchase all of the outstanding interests in the Company but the Company has an election under Code Section 754 in effect, the purchaser will be able to write up its share of the basis of each of the Company's assets.[19]

2. Asset sale. In an asset sale, the Company is treated as selling, and the purchaser is treated as buying, the various Company assets separately for allocable portions of the aggregate purchase price. Thus, because the Company's owners report their shares of the Company's income or loss directly under Code Section 702 (with character passing through as well), the mix to the Company's owners of capital gain (or loss) and ordinary income (or loss) will depend on the Company's assets and the allocation of the purchase price. Like S corporation shareholders in an asset sale, the Company's owners will prefer to allocate the purchase price so as to maximize the amount of long-term capital gain (or ordinary loss) to be reported by them on the sale. The purchaser, on the other hand, will likely want to allocate as much purchase price as possible to assets that are likely to turn over in the short term or that have short depreciation or amortization schedules.

3. Inapplicability of reorganization rules. The reorganization rules of Section 368 and its ancillary provisions do not apply to partnerships. Accordingly, if the Company is a partnership for tax purposes, it may not be acquired for stock of a corporate acquiror on a tax-deferred basis under those rules.[20] While conversions of partnerships to corporations can often be effected without the recognition of income, a conversion of the Company effected as part of a plan culminating in the receipt by the Company's owners of stock of a corporate acquiror can be disregarded as transitory (or be taxable for failure to satisfy Section 351), particularly if discussions with the prospective acquiror have commenced.[21]

c. Suspended Losses. If the Company is a C corporation with a net operating loss, the loss may be limited as to its usefulness going forward under Code Section 382 if the transaction is structured as a stock sale or never used if the transaction is structured as an asset sale (to the extent not used against income from the asset sale).[22] If the Company is an S corporation or tax partnership, suspended losses of the owners from the Company may be freed up (including for use against income from the sale) if the sale (i) in the case of losses suspended under a basis limitation or the "at risk" rules of Code Section 465, increases owner bases or amounts at risk (in particular, through allocations

17 The selling owners' shares of the Company's liabilities are included in their selling prices.

18 See Rev. Rul. 99-6, 1999-1 CB 432.

19 It is worth noting that the rules for purchasing an interest in a partnership with a Section 754 election in effect can be more favorable than the rules for purchasing stock in an S corporation with a Section 338(h)(10) or Section 336(e) election in effect in that (i) there is no 80% minimum purchase requirement for basis adjustments to be available as a result of a Section 754 election and (ii) if the purchase is of less than 100% of the outstanding interests, the Section 754 election does not require the recognition of all of the gain inherent in the entity's assets. It should also be noted that a purchase and sale of 50% or more of the interests in a partnership's capital and profits within a period of twelve months terminates the partnership for tax purposes under Code Section 708(b)(1)(B). Upon such a termination, the partnership is deemed to contribute its assets, subject to its liabilities, to a new partnership and to then distribute the interests in the new partnership to its partners in liquidation. If the partnership terminates under Code Section 708(b)(1)(B) as a result of a purchase of interests, the purchasing partners get basis adjustments as a result of the terminated partnership's Section 754 election.

20 Section 351 or Section 721 may provide "tax free" treatment entirely or in part, however, if the transaction involves the contribution of equity or assets of the Company to a corporation or partnership for equity.

21 See, for example, Rev. Rul. 70-140, 1970-1 CB 73.

22 Section 382 can also limit the usefulness of certain built-in losses that have not yet been recognized.

of income from the sale) or (ii) in the case of losses suspended under the "passive activity loss" rules of Code Section 469, results in the affected owners having made taxable dispositions of their interests in the activity that generated their losses.[23]

II. DEFERRED OR CONTINGENT PAYMENTS

It is not uncommon for a portion of the purchase price to be paid over time or as certain performance goals are met (with the deferred payment obligation evidenced by a note or by the purchase and sale agreement). In addition, a portion of the purchase price may be held back or deposited into an escrow account to secure obligations of the Company or its owners to indemnify the purchaser for breaches of representations, warranties and covenants.

a. Original Issue Discount. If a deferred portion of the purchase price does not bear an adequate interest rate, part of the deferred portion may be recharacterized as interest under the original issue discount rules of Code Sections 1272 through 1275 and the regulations thereunder. In addition, interest that is not payable at least annually as it economically accrues may have to be reported as it accrues on the basis of a constant yield to maturity rather than as it is actually paid (so that the Company or its owners may have to report interest income for a year in which they receive no payments).

1. Contingent payments. In the case of a contingent deferred payment, the portion of the payment that is interest is generally the amount by which the payment exceeds the present value of the payment discounted back to the closing date at a "test rate" applicable to the sale (with the present value of the payment being principal). Contingent interest is generally reported as it becomes fixed (subject to special rules that apply when the contingent interest is payable more than six months after becoming fixed).

b. Installment Method. Generally, a seller's gain on a deferred payment sale is reported under the installment method of Code Section 453 unless the seller elects not to use the method. Under the installment method, the seller computes the percentage (referred to as the "gross profit ratio") which his or her overall profit on the sale (exclusive of interest) represents of the overall amount he or she will receive from the sale (other than as interest, and excluding certain "qualifying indebtedness" to be assumed or taken subject to by the purchaser to the extent not in excess of the seller's adjusted basis in the property being sold). He or she then multiplies each "payment" he or she receives by that gross profit ratio to determine the portion of the payment that is gain.

1. Contingent payments. The contingent payment provisions of the installment sale rules make some unfriendly assumptions.[24] For instance, if there is a cap on the amount that the seller can receive, the seller computes his or her gross profit ratio by assuming that he or she will receive the maximum amount he or she can receive. If there is no cap on the amount that the seller can receive but there is a fixed period over which the seller can receive payments, the seller does not compute a gross profit ratio and instead allocates his or her adjusted basis in the property being sold to the years in which he or she may receive payments in equal annual portions (or in accordance with an arithmetic component consistent with the manner in which payments may be made unless it is inappropriate to assume that payments will be made in accordance with the component) and then subtracts the portion allocated to any year in the payment period from the payment made for that year. In any event, the assumptions required by the regulations can overstate the portions of the early payments to the seller constituting gain and leave the seller with unrecovered basis after he or she has received all the payments to be made by the purchaser.

2. Escrow and security arrangements. If a portion of the purchase price is deposited into an escrow account to secure representations and warranties of the seller, the deposit into the escrow account is generally not

23 Because suspended losses retain their original character, investors in an S corporation or tax partnership whose shares of the entity's losses are suspended under the "passive activity loss" rules of Section 469 may ultimately be able to claim any losses they actually have on their investments as ordinary losses when the losses free up. Outside of Section 1244, their investment losses generally are capital losses when they sell or otherwise dispose of their investments in the entity if the entity is a C corporation.

24 See Regulations Section 15A.453-1(c).

treated as a "payment" triggering the reporting of gain for the seller. Instead, when an amount is released to the seller from the escrow account, the present value of the released amount (discounted back to closing at the applicable "test rate") is a payment, and the balance is interest. Notwithstanding the general rule, care must be taken in structuring escrow and other security arrangements to avoid creating "payments."

3. Ineligible income. Depreciation recapture under Code Sections 1245 and 1250 (including by way of Section 751) and gains from sales of inventory and publicly traded stock are not eligible for reporting under the installment method.[25] Care must be taken in structuring deferred payment sales of interests in tax partnerships that hold assets to which the installment method would not apply.[26]

4. Section 453A interest charge. Under Code Section 453A, a seller who holds more than $5 million in installment obligations may be subject to an interest charge on the deferred tax liability with respect to the balance in excess of that amount.

5. S corporations and Sections 453(h) and 453B(h). If, within twelve months after adopting a plan of liquidation (to which Code Section 331 applies), an S corporation sells its assets and distributes an installment obligation from the sale to its shareholders in complete liquidation, (i) under Code Section 453B(h), the corporation's distribution of the installment obligation to its shareholders does not trigger the gain inherent in the obligation, and (ii) under Section Code 453(h), the shareholders may report their gains under the installment method as they receive payments on the distributed obligation as if they had sold their shares for the obligation (with the character of the gain being determined, under regulations to be issued, by reference to the gain that would have been recognized by the S corporation had it received the payments).[27] If the purchaser would purchase the S corporation's assets for cash and an installment obligation, it might be better for the S corporation's shareholders to have the cash that would otherwise be paid at the closing of the sale instead be included in the amount of the installment obligation and then paid on the installment obligation shortly after the S corporation has sold its assets and distributed the installment obligation in completion of its liquidation.[28]

6. Section 338(h)(10) elections and notes. If the purchaser in a stock purchase for which a Section 338(h)(10) election is made (see I.a.3., "Stock sale treated as asset sale," above) pays part or all of the purchase price for the stock with a note, "old" Company is treated as having received the note in its deemed asset sale (with the deemed asset purchaser being the obligor) and then as having distributed the note in its liquidation. As a result, the installment method applies to the note subject to any other applicable exceptions.[29]

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25 See Code Sections 453(b)(2), 453(i) and 453(k)(2)(A).

26 See Rev. Rul. 89-108, 1989-2 CB 100. Rev. Rul. 68-13, 1968-1 CB 195 provides that, where multiple assets are sold for cash and a note, the parties can agree on the allocation of the cash and the note among the various assets (for example, the seller might want to allocate the cash to assets ineligible for installment sale reporting and the note to assets eligible for installment sale reporting so as to minimize the amount of income reported for the year of the sale). In the absence of such an agreement, the cash and note are allocated on a pro rata basis among the various assets.

27 If the corporation were a C corporation, the shareholders could report their gains under the installment method as they receive payments on the distributed obligation as if they had sold their shares for the obligation, but the distribution of the obligation by the corporation would require the corporation to recognize the gain inherent in the obligation. That is, Section 453(h) would apply to the shareholders, but Section 453B(h) would not apply to the corporation.

28 Cash paid to the S corporation by the purchaser can increase the amount of S corporation gain to be reported by the shareholders for the year of the S corporation's liquidation. The gain increases the shareholders' bases in their shares. If a shareholder receives cash and an installment obligation in the liquidation of the S corporation, the shareholder's stock basis (as increased by his or her share of the gain recognized by the S corporation on the sale) is allocated between the cash and the installment obligation in proportion to the relative amounts of the cash and the installment obligation. The shareholder has additional gain for the year of the liquidation to the extent that the cash he or she receives exceeds the portion of his or her stock basis allocable to the cash. The portion of his or her stock basis allocable to the installment obligation becomes his or her basis in the installment obligation, with his or her gross profit ratio being (i) the amount of the installment obligation minus his or her basis in the obligation over (ii) the amount of the obligation. Depending on the circumstances, moving the cash payment from a payment at the closing of the sale to an initial payment on the installment obligation post-liquidation can avoid additional gain to the shareholders for the year of the sale and liquidation resulting from their receipt of cash from the corporation for shares with lesser bases.

29 See Regulations Sections 1.338(h)(10)-1(d)(8) and 1.338(h)(10)-1(e), example 10. The Regulations under Code Section 336(e) indicate that the rule applies in transactions governed by Section 336(e) elections as well.

7. **Distribution of installment obligation by partnership.** Under Regulations Section 1.453-9(c)(2), a partnership's distribution (governed by Code Section 731) of an installment obligation should not trigger the gain inherent in the obligation under Code Section 453B.

c. Reorganization. If the transaction is intended to qualify as a reorganization under Code Section 368, care must be taken to ensure that the arrangement does not jeopardize that qualification.[30]

III. EMPLOYEES AND OTHER SERVICE PROVIDERS

a. Outstanding Options and Restricted Equity. Often, employees and other service providers of the Company have Company options or shares of restricted Company equity. The consequences of their participation in the sale transaction can vary significantly.[31]

1. **Optionholders.**

A. New option. Code Section 409A subjects a service provider who is granted an option that is "in the money" when granted (an option is "in the money" if the underlying equity is worth more than the exercise price of the option) to tax and a 20% penalty on the option's spread (the excess of the value of the underlying equity over the exercise price) as the option vests and thereafter as the underlying equity appreciates.[32] If an option-holder exchanges a Company option that is an incentive stock option (or "ISO") under Code Section 422 for an option to purchase equity of the purchaser (or a parent or subsidiary of the purchaser), the new option will also be an ISO, and will not be subject to Section 409A, if (i) the exchange of the old option for the new option is "a substitution of a new option for the old option, or an assumption of the old option, by an employer corporation, or a parent or subsidiary of such corporation, made by reason of a corporate merger, consolidation, acquisition of property or stock, separation, reorganization, or liquidation," (ii) the terms of the new option are not more favorable to the optionholder than those of the old option (no "additional benefits"), (iii) the spread on the new option as of the time immediately after the exchange is not greater than the spread on the old option as of the time immediately before the exchange, and (iv) the value of the stock subject to the new option as of the time immediately after the exchange is not greater than the value of the stock subject to the old option as of the time immediately before the exchange.[33] An option that is not an ISO (referred to as an "NQO") issued to a Company optionholder in exchange for a Company NQO can similarly avoid Section 409A if the ISO substitution test would have applied had the old and new options been ISOs.[34]

B. Cash or property. If the optionholder receives cash or purchaser equity for the option, he or she generally recognizes the amount of cash or the value of any purchaser equity he or she receives (less any amount he or she pays to exercise the option) as ordinary income (although, if the optionholder receives purchaser equity that is substantially nonvested, the tax consequences are postponed until the equity ceases to be substantially nonvested unless the optionholder makes a timely Section 83(b) election with respect to the purchaser equity).[35] Any

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30 See Rev. Proc. 84-42, 1984-1 CB 521.

31 To keep things simple, unless otherwise noted, it is assumed in this outline that holders of options will receive only new options, cash and/or purchaser equity, and that holders of restricted equity will receive only cash and/or equity, of the purchaser in the transaction.

32 The applicability of Section 409A to corporate options has been clarified somewhat by regulations. Further guidance as to partnership options, however (including clarification that partnership equity can be valued at liquidation value), remains forthcoming. In any event, it is assumed in this outline that any options to purchase interests in the Company were not themselves subject to Section 409A.

33 See Code Sections 424(a) and (h) and Regulations Sections 1.424-1(a) and (e). If vesting is accelerated, care should be taken to avoid a violation of the $100,000 limitation of Code Section 422(d).

34 See Regulations Section 1.409A-1(b)(5)(v)(D).

35 See Code Section 424(c), however, for an exception to the term "disposition" for purposes of the ISO "disqualifying disposition" rules for transfers made in connection with reorganizations under Section 368. It should also be noted that the spread on an ISO will be subject to employment tax if the ISO is cashed out but not if the ISO is exercised and then sold in a "disqualifying disposition."

deferred or contingent payments made to the optionholder will not be subject to Code Section 409A if the payments are made on the same schedule and on the same terms and conditions as they are made to the Company's equityholders and are fully paid within five years after the sale.[36]

2. **Restricted equityholders.** The consequences of the transaction to a holder of substantially nonvested Company equity generally depend on whether or not the holder has made a timely Section 83(b) election with respect to the Company equity (unless, at least under current law, the restricted Company equity is a partnership profits interest deemed to be owned by the holder notwithstanding his or her failure to make a Section 83(b) election). If the holder did not make a timely Section 83(b) election with respect to the Company equity (unless, at least under current law, the Company equity is a partnership profits interest deemed to be owned by the holder notwithstanding his or her failure to make a Section 83(b) election), he or she generally recognizes ordinary income equal to the amount of cash and the value of any purchaser equity he or she receives for the Company equity (less the amount he or she paid for the Company equity). If any purchaser equity received by the holder is itself substantially nonvested upon receipt, however, the income with respect to the purchaser equity is deferred until the purchaser equity ceases to be substantially nonvested (at which time the income is determined with reference to the then value of the equity) unless the holder makes a timely Section 83(b) election with respect to the equity. If the holder made a timely Section 83(b) election with respect to the restricted Company equity (or, at least under current law, the restricted Company equity is a partnership profits interest deemed to be owned by the holder notwithstanding his or her failure to make a Section 83(b) election), the holder generally participates in the transaction as the owner, for tax purposes, of the restricted Company equity.[37]

b. Golden Parachutes. Special rules apply under Sections 280G and 4999 to payments (referred to as "parachute payments") in the nature of compensation by a corporation to a "disqualified individual" that (i) are contingent on a change of control of the corporation and (ii) have an aggregate present value equal to at least three times the disqualified individual's "base amount." A "disqualified individual" is an individual who performs personal services for the corporation and who is either an officer or shareholder (holding more than 1% by value of the corporation's stock) of the corporation or is among (or would be among, if he or she were an employee) the highest paid 1% or, if less, 250 employees of the corporation. An individual's "base amount" is his or her average annualized compensation from the corporation during the five year period before the year of the change of control. Under the rules, an "excess parachute payment" (the amount by which any parachute payment exceeds an allocable portion of the disqualified individual's base amount) is non-deductible by the corporation and is subject to a 20% excise tax in the hands of the disqualified individual.[38]

1. **Accelerated vesting.** The acceleration of the vesting of Company options or restricted stock can give rise to parachute issues. If vesting after the change of control would have depended only on the continued performance of services for the Company for a specified period of time, however (and acceleration is attributable, at least in part, to services performed before the change of control), the amount that must be taken into account as a payment contingent on the change of control of the Company is limited to the time value of the acceleration (plus an amount reflecting the lapse of the obligation to continue performing services).[39]

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36 Payments made to the optionholder when and as any unvested portion of the option would have vested, however, may be subject to Section 409A. Guidance on this issue may be forthcoming.

37 In that case, the tax results to the holder will depend on the tax classification of the Company and the structure of the sale transaction. See I. and II. above. Under certain circumstances, and depending on the tax classification of the purchaser, Company equity held by employees and other service providers may be "rolled" into equity of the purchaser on a "tax-free" basis under Code Section 351 or Code Section 721.

38 It is not unusual for the purchaser to request a representation and warranty to the effect that none of the amounts paid by it will be excess parachute payments.

39 See Regulations Section 1.280G-1 Q/A 24.

2. Shareholder approval. If the Company is private, the applicability of the parachute rules can be avoided by subjecting what would otherwise be parachute payments to approval by the Company's shareholders. Unfortunately, for the approval to achieve its purpose, the right of the disqualified individual to receive the payment must be made contingent on the approval.

c. <u>Covenants Not to Compete; Consulting and Employment Arrangements.</u>[40] Key personnel of the Company may be asked not to compete, either individually or on behalf of another entity. Alternatively (or additionally), they may be asked to provide services to the purchaser as employees or consultants. Non-compete, employment and consulting payments are ordinary income in the hands of their recipients.[41]

40 Care must be taken to avoid Section 409A in structuring deferred compensation arrangements.

41 A non-compete entered into in connection with an acquisition of a business is an amortizable Section 197 intangible. Accordingly, the purchaser amortizes the amount it pays for any non-compete agreement over fifteen years. Any employment or consulting payments made by the purchaser are deductible by the purchaser under its regular method of accounting so long as the payments are bona fide and reasonable in relation to the services the purchaser receives for them. The purchaser is generally required to amortize any employment or consulting payments that are not bona fide and reasonable over fifteen years.

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