Federal Tax ADVISORY ■

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Buying Assets

Background

Once upon a time, it was common to sell and buy an ongoing business by deed, bill of sale and assignment and assumption of ongoing contracts. This method of commercial conveyance (sometimes called a "bulk sale") was not limited to hard assets. It can also convey goodwill and other intangibles not represented by contract rights, licenses or the like. It produced the best of all buyer-side tax results: the buyer got a fair market value basis in the assets and did not acquire the seller's liabilities, except as voluntarily assumed.

Perhaps certain liabilities, such as environmental liabilities, might be imposed on the asset or business buyer by operation of law. But normal liabilities, like the seller's tax liabilities, usually could not be collected from a buyer that had paid fair value and thus was a bona fide purchaser for value under state fraudulent conveyance law.

This conveyancing method was so common that it was a major feature in transactions of concern to the IRS. Sellers had a tendency to allocate more of the purchase price to assets with higher basis, or that would produce a capital gain such as goodwill. Buyers had a tendency to allocate more of the purchase price to assets that could be quickly written off, which did not include goodwill. The resulting whipsaw effect on the Treasury led to the enactment of Sections 197 and 1060 in 1986.

Stock Purchases

Of course, a simpler transaction could occur if the business was incorporated and the buyer could buy the stock, or was in a partnership and the buyer could buy the partnership interests. However, a stock purchase could be undesirable for several tax reasons, including (1) acquiring unwanted tax history of the corporation and (2) not obtaining an asset basis step-up to fair market value reflecting the purchase price.

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An asset basis step-up for the assets of a target corporation can be obtained domestically, usually without double taxation, through a Section 338(h)(10) or Section 336(e) election, and abroad with a Section 338(g) election. However, neither election frees the target of its prior liabilities, including particularly tax liabilities. An asset basis step-up for the assets of a target partnership can be obtained through a Section 754 election, and there is no concern about acquiring prior tax liabilities.

Disregarded Limited Liability Companies

Focusing on the target corporations, avoiding their tax and non-tax liabilities is a real concern to many buyers. The problem has become more difficult due to the advent of the limited liability company, which otherwise makes buying ongoing businesses much simpler than the old days of deeds and bills of sale. The good feature of the LLC-owned business is that the buyer can buy the LLC interests and obtain ownership of all of its business assets without having to retitle them.

The downside is that in cases where the target LLC had checked the box to be taxed as a corporation, its acquisition brings with it the entity's federal tax liabilities as a corporation, even if it is not treated as a corporation when bought.

Example: Target X corporation engages in an F reorganization in which it merges into a disregarded LLC owned by a New Target X corporation. New Target X sells the LLC. Even though New X is the successor of X for all tax purposes, the LLC remains liable as an entity for any federal tax liabilities it incurred as a corporation.

Two Suggestions

This example suggests that corporations might plan ahead by organizing new businesses in disregarded LLCs, whether they are also in separate subsidiary corporations or not. This is not a new idea. Some corporate groups have replaced their consolidated return structure with a collection of disregarded entities. However, even without going that far, beginning a new venture in a disregarded LLC owned by a subsidiary group member can be worthwhile in terms of future dispositions.

If the business is not already in an LLC owned by a corporate seller, and if an asset purchase is desired, then one of two things must happen: either (1) the seller puts the business into an LLC by deed and bill of sale (not by an F reorganization) and sells the LLC interests, or (2) the buyer buys the assets into an LLC.

Either method usually will be effective to insure buyer freedom from normal liabilities of the seller. However, the buyer may have an additional concern: ensuring that it "got everything." This, though, should not be any more of a concern with a conveyance of assets than with a purchase of stock or LLC interests. In the latter case, representations will be used to ensure inclusion of all the business in the entity; in the former case, language like such representations can be used in the bill of sale and assignment.

Conclusion

Buying and selling businesses is the most common corporate transaction with tax consequences. Buyers should not be unduly wary of asset acquisitions: they are the best method for many acquisitions.

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