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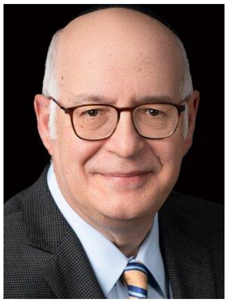
6 Tips For Maximizing After-Tax Returns In Private M&A Deals

By **Isaac Grossman and Daniel Studin** (June 25, 2024, 4:07 PM EDT)



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Numerous provisions of the U.S. tax code that provide significant tax breaks to business owners and other taxpayers are set to expire on Jan. 1, 2026.

In its 2025 budget, released on March 11, the Biden administration proposes to roll back certain of these benefits before their original sunset date and enact other legislation designed to increase taxes on wealthy Americans.

Whether any of that happens, and what other federal tax law changes may be in store, will be dictated largely by the results of upcoming elections.

However, the current focus on potential tax legislation is likely to spur a surge in the sale of private businesses, especially if interest rates begin to cool.

Tax planning for the sale of a private business should begin well before a deal is on the table. This article lays out six suggestions that a potential seller should consider in order to maximize the after-tax proceeds of the transaction.

1. Target Cleanup

First, a potential seller should consider cleaning up the target for any tax, financial or structural abnormalities. For example, if the target is a Subchapter S corporation, the seller should confirm that it has copies of its in-force Subchapter S election.

If the target has one or more inactive subsidiaries, the seller should consider liquidating them. Additionally, in certain cases, merging affiliated entities in one or more tax-free reorganizations could make the target more attractive to potential buyers.

Unfortunately, many sellers do not address these types of issues before a potential buyer is in the data room. As a result, cleanup issues sometimes derail or stall negotiations and cause the buyers to request a reduction in purchase price or an indemnity and escrow.

2. Modeling

Next, a potential seller should model the potential tax on the transaction to help it identify its preferred deal structure and key points for negotiating the deal.

Where the target is a corporation, the tax ramifications of a stock sale versus asset sale could be significant for both the seller and the buyer. Generally, the seller will prefer a stock deal.

This is because, under current law, long-term capital gain is taxed at preferential rates and, upon a sale of stock of a corporation, the sellers generally realize only capital gain.

By contrast, in the case of a sale or deemed sale of assets, the seller might have ordinary income attributable to certain assets including receivables, inventory and depreciable assets.

The buyers, on the other hand, will typically prefer to acquire the assets or equity of a pass-through or disregarded entity.

This is because in an asset deal, the buyer steps up the tax basis in the acquired assets to reflect the purchase price — other than in the form of rollover equity, discussed below — and by consequence, also enjoys enhanced depreciation deductions going forward.

In an asset deal, the buyer is also exposed to fewer preclosing liabilities.

In many instances, the parties will agree to an asset sale but gross up the purchase price in order to account for the seller's increased tax bill. However, several considerations will be relevant to that decision.

For instance, a seller with small business stock that may qualify for an exclusion from tax upon sale may have more to lose from an asset sale than a seller without qualified small business stock.

Conversely, the state and local tax deduction cap and pass-through entity tax rules could actually militate in favor of an asset deal due to limits on the deductibility of state and local taxes upon a sale of equity.

Having a handle on these considerations and mapping out the alternatives early could give the seller an advantage in negotiating the deal and avoid deal drag.

3. Rollover Equity and Earnout Analysis

Once cleanup is out of the way, and initial tax modeling is performed, a potential seller should determine its willingness to accept different forms of consideration and how different forms of consideration would affect its tax bill.

For instance, many buyers insist on rollover equity — i.e., an ongoing interest of the seller in the target or the buyer's entity and its existing businesses.

This is because rollover equity provides the buyer with easy access to recovery in the event of an indemnity claim and encourages the sellers to help maintain and grow the acquired business for the buyer's benefit.

Thus, before negotiations begin, a potential seller should consider its willingness to maintain or receive rollover equity.

There are three tax provisions that are typically used to provide the seller with tax-free, or tax-deferred, rollover equity in the buyer's business.

The first tax provision is Section 368 of the Internal Revenue Code, which applies to a variety of tax-free reorganizations, such as the most basic forward and reverse corporate mergers.

However, these provisions generally apply only to the acquisition of corporations by corporations, and require that a minimum of approximately 40% of the consideration be in the form of stock in the buyer or affiliates.

The second tax provision is IRC Section 351, which permits a tax-free transfer of property to a corporation in exchange for stock of that corporation, provided the contributors, as a group, control the transferee corporation immediately after the contribution.

However, this provision is often difficult to utilize where the buyer is an existing business and is not funding the acquisition with additional contributions from its shareholders — such as an add-on transaction funded with the buyer's excess cash and buyer-debt financing.

The third tax provision is IRC Section 721, which permits a tax-free transfer of property to a partnership in exchange for equity of the partnership. Section 721 is more permissive than both Sections 351 and 368.

Many deals also involve earnouts or similar contingent debt obligations.

The installment sale provisions in Section 453 permit the sellers to defer gain attributable to payments not yet received under certain installment note obligations, including typical earnouts drafted as part of a purchase agreement.

However, there is a $5 million limit on the amount of notes that a taxpayer may hold without incurring an interest charge on the deferred tax liability.

4. Residency; Estate Planning for Tax Minimization

Another important consideration for a potential seller is his or her residency plans following the sale. There is a significant difference in tax rates among the states and cities within the U.S.

If the seller is considering a move to a so-called retirement state such as Florida or Arizona — i.e., a state with no income tax or estate tax — accelerating that move to precede the exit could significantly reduce state and local taxes payable upon the sale.

Many individuals are surprised to learn that changing residency for state tax purposes is not necessarily accomplished solely by spending six months and one day in another jurisdiction, but that the analysis often includes a facts and circumstances, or domicile, test as well.

Making the best case for meeting the domicile test typically involves a number of steps — e.g., obtaining a new driver's license, registering to vote, changing the status of club memberships and filing certain local forms.

Therefore, a seller intending to establish a new tax residency prior to sale should provide ample lead time to accomplish these tasks.

Relatedly, incorporating the sale of a business into an overall estate plan could maximize tax savings.

For instance, a potential seller should consider whether a transfer of some or all of the seller's interests in the business to an estate-protected trust prior to a third-party sale would reduce aggregate taxes for the seller and the seller's family.

If a decision to transfer equity to a trust is made early enough, the interests gifted or sold might carry a value for purposes of that intrafamily transaction that is significantly below the value of the interests upon the third-party sale.

In that case, in addition to shifting post-close appreciation on the proceeds outside of the seller's estate, the seller would have maximized the use of the seller's gift tax exemption by causing appreciation between the intrafamily transfers and the third-party sale to accrue in the hands of the trustee, as opposed to the seller.

In the event that trust planning is incorporated, a key decision will be how to structure the trust for income tax purposes. If the trust is structured as a so-called grantor trust, the seller would retain the obligation to pick up the trust's income taxes on a going-forward basis.

In many cases, this turbocharges the estate planning, as the trust would pick up no tax on the sale and no tax on income going forward, while the grantor trust status is retained.

As a result, the trust assets would grow unencumbered by taxes. By the same token, the seller's estate is depleted by the taxes attributable to the trust, which further reduces the seller's projected wealth transfer tax liability.

The combination of these tax attributes creates a win-win situation from an estate tax mitigation perspective that can greatly amplify the benefits of the transaction during future periods.

Alternatively, the trust could be structured as a nongrantor trust — i.e., an independent taxpayer.

With a nongrantor trust, the seller could double or, with multiple nongrantor trusts in certain circumstances, potentially even further multiply — i.e., stack — the qualified small business stock exclusion under Section 1202 of the Internal Revenue Code.

Using a nongrantor trust also opens the door to potentially powerful state and local tax planning opportunities outside the context of qualified small business stock.

If the trust is set up in a state that does not charge tax to trusts on the basis of residency, some or all income earned by the trust could escape state and local income taxes, even if the seller or the seller's beneficiaries reside in a state with income tax.

In the correct circumstance, state and local income taxes can even be avoided on the sale of the business itself.

This is true, for instance, in a stock sale of interests in a Subchapter C corporation by a nongrantor trust resident in a state that does not charge tax to trusts on such basis. For this to work, however, the stock must have been transferred to the trust prior to the time that the material terms of the third-party sale are set.

Therefore, such planning should be considered before a binding letter of intent is signed.

Note that a potential seller is not necessarily limited in this planning by his or her remaining gift tax exemption.

By selling interests within the family — e.g., to an estate-protected trust in exchange for a promissory note — the seller could shift vastly more equity, and therefore, vastly more future appreciation, out of the estate.

A trust could be considered credit-worthy for purposes of such a sale by, for instance, having preexisting assets — i.e., seed capital — equal to a portion of the equity sold to the trust. Seed capital of at least 10% is customary.

5. Purchase Price Allocation

A potential seller should also focus on purchase price allocation. These rules, found in various provisions throughout a purchase agreement, can significantly affect a seller's net tax bill.

For example, in an asset acquisition or deemed asset acquisition, the purchase price — plus assumed liabilities — will be allocated among the different assets by the parties under the agreement pursuant to a schedule or as part of a post-closing process.

The amount of ordinary income and capital gain realized by the seller will be determined based on the proceeds allocated among the ordinary assets — e.g., receivables, inventory and PPE — and capital assets.

Similarly, many purchase agreements include a covenant not to compete for the seller. Any amount allocated to this covenant will be ordinary income for the seller.

Due to enforceability concerns, this covenant may be added even where the seller is separately signing an employment agreement that includes a parallel covenant. It is imperative for the seller to limit the amount of consideration allocable to this covenant and other ordinary income assets under the purchase agreement.

6. Investment of Proceeds

Finally, a seller should consider how it will invest proceeds of the transaction, and how that decision will affect the seller's tax bill.

One such decision should be whether the seller might seek to invest proceeds in a qualified opportunity fund. A qualified opportunity fund is an entity with substantially all of its assets invested in certain identified low-income communities.

Subchapter Z of the code permits a seller to invest cash proceeds that are otherwise taxable into a qualified opportunity fund investment within a defined time period, 180 days, and thereby temporarily defer the tax on the original sale.

If the seller holds a qualified opportunity fund investment for an extended time period, seller also attains tax benefits associated with the investment itself.

Conclusion

Selling a business is a major undertaking. However, with proper planning, the sale process need not be harrowing; the tax costs can be reduced and the overall proceeds may even be increased.

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