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THE BUSINESS SALE PROCESS

A Step-by-Step Guide to Buying or Selling a Company with Confidence and Clarity

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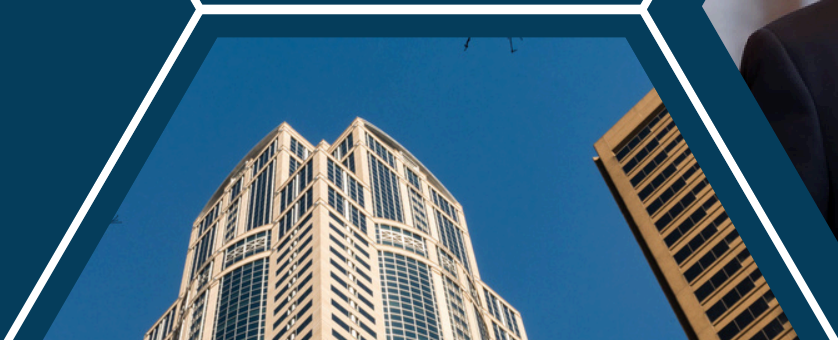

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A. THE BUSINESS SALE PROCESS

Buying and selling a business can be an enormous financial decision - whether you are selling the business you have built over the years, or buying a business, either as a way to expand an existing enterprise, or perhaps, as a way to start a new venture. Understanding the legal and tax issues of a sell/buy transaction *before you enter into the transaction* should help you appreciate the enormity of your decisions and reduce your risk. Whether you are selling or buying a business, there are a number of "steps" to consider: determining a fair price, conducting due diligence, understanding the tax impacts of the transaction, negotiating and drafting key agreements, and implementing a process that results in a smooth closing.

Understanding *how* a business should be valued is critical to negotiating a fair purchase price. The parties may have different opinions on valuing the *goodwill* of a business and whether the business's past success will result in a profitable future. Recognizing that there are differences of opinion (some valid) should help a seller and buyer come to a clearer understanding of a fair price.

The due diligence process allows the parties to discover (or uncover) material issues which may affect their willingness to complete the transaction. Due diligence may be very general and may only consist of a review of several years of financial statements or may be very detailed and involve an exhaustive review of all aspects of the business.

The federal and state tax consequences of a business sale must be analyzed to fully understand and plan the transaction. While tax law generally governs allocations of purchase price, the parties may have differences of opinion regarding allocations to goodwill or even personal goodwill of the owners. Each transaction will have federal, state, and possibly local tax consequences, and the form of the transaction (equity or asset purchase), will also add to the complexity of the analysis.

Transaction documents may be thought of as *generic* but can actually contain nuanced provisions which favor either the seller or buyer. The goal of any purchase agreement is to clearly set forth a party's obligations and to fairly allocate risk between the seller and buyer, given the transaction.

Finding a Buyer/Seller: Presuming the decision to sell (or buy) had been made, the best method for finding a buyer (or seller) will depend on the size of the transaction, the nature of the industry and whether the courtship will be conducted through one-to-one communications or a bid/auction approach. It can mean hiring a broker or simply reaching out in the industry by word of mouth. There is no "right" approach. Each set of circumstances may demand a different process. But the following are some thoughts:

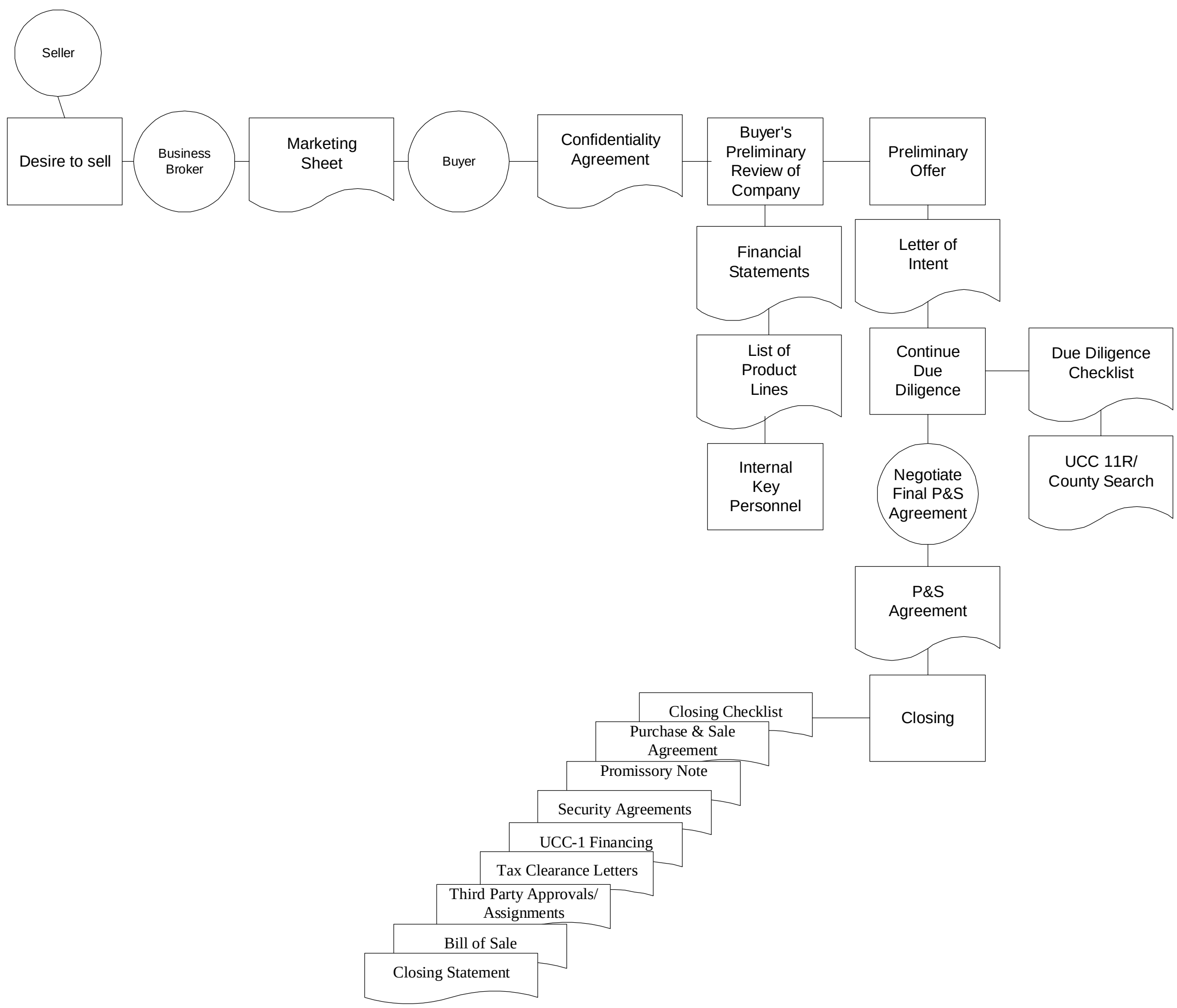
Contact Local Competitors: All business owners know the identities of their closest competitors and can initiate contact on their own and without outside assistance other than perhaps legal counsel. Although the protection of confidential information is more difficult in dealing with competitors, they often represent the most appealing suitor in that the transaction will not only facilitate cost savings and synergies but may also eliminate some of the more damaging effects of competition.

Contact Strategic Prospects: Sometimes the best suitors are companies engaged in similar business operations in a different region. Such a company might either wish to expand territorially (and hence be a suitable buyer) or pursue an exit strategy for its owners (and hence be a suitable seller). Similarly, companies engaged in related businesses may open vertical integration possibilities and also be attractive.

Contact Business Brokers or Investment Banking Advisors: Brokers and/or investment banking advisors can often locate prospective suitors from their own contacts and undertakings or can locate and/or form interested investment groups. They can also assist in preparing, evaluating and disseminating the transaction information (usually in the form of a confidential placement memorandum) and, if appropriate, in conducting a bid and auction process to narrow the field of suitors.

The following is a general outline of a sales transacton.

OUTLINE OF THE SALE PROCESS



B. CONFIDENTIALITY AGREEMENTS

The confidentiality agreement plays a key role in the sale process. Before any serious discussions take place, and certainly before the exchange of proprietary information, the seller and buyer should enter into a confidentiality agreement.

The confidentiality agreement serves three primary purposes:

- Sets forth the obligations of the parties by defining what is meant by "confidential information", how such information can be used and by whom;

- Adds additional protection to state law trade secret protections; and

- Helps the parties demonstrate they used reasonable means to protect their confidential information.

A confidentiality agreement restricts a party's use of the confidential information obtained through its due diligence. Confidentiality agreements can impose significant obligations on a party and should be reviewed carefully by counsel. The following concerns should be addressed:

1. **Parties and Transaction**. It is critical to properly define all the parties to the agreement, as well as the nature of the transaction for which the information is being disclosed. The agreement should reference other persons who may have reason to have access to the information, such as employees, agents, attorneys and accountants.

2. **Confidential Information**. Generally, from the seller's perspective, the definition of "confidential information" should be broad. The buyer will typically want a narrow definition, e.g., limiting confidential information to documents specifically marked confidential by the seller.

It is important to note that confidential information may also include oral discussions and interviews with the seller's executives and other key employees.

> **Practice Tip**: *In the event that either seller or buyer demand confidential information be stamped "confidential," the clause providing that "inadvertent failure to stamp a document confidential is not a waiver of its confidentiality" should be inserted to protect the seller.*

3. **Uniform Trade Secrets Act**. Note: under state law trade secrets may be also protected from disclosure. Information is a trade secret if it:

Derives economic value from not being generally known to other persons who can obtain economic value from its disclosure or use; and

Is subject to efforts that are reasonable under the circumstances to maintain its secrecy or confidentiality.

4. **Return/Destruction of Materials**. If the transaction is not closed, the buyer should either return or certify that is has destroyed the information provided by the seller. However, a buyer may wish to retain an "archived" copy of confidential information, which can be used as proof by the buyer in a later controversy over what information was actually provided by the seller.

5. **Restricting Access/Use of the Confidential Information**. Confidentiality agreements define who may have access to the information, and under what conditions. A confidentiality agreement typically provides that the information will not be disclosed except to persons who have a "need to know" and then, only if such persons receive a copy of the confidentiality agreement and agree to be bound by its terms, in writing.

6. **Nondisclosure of Transaction**. The fact that negotiations are taking place should be kept secret. The seller does not want its suppliers and customers to be aware that the company is for sale.

7. **Noncompetition**. The seller may desire a buyer non-compete with the justification that that without the disclosure of the seller's confidential information, the buyer would have difficulty entering into the company's business. Many buyers will resist entering into a restrictive covenant, especially if they desire to establish a presence in the territory of the seller. In any event, the restrictive provisions should be reasonable in both scope and duration.

8. **Information in Public Domain**. A seller cannot make confidential information that is already public, (or becomes public thru no fault of buyer). However, the agreement may shift the burden of proving no fault to the buyer.

9. **Legal Proceedings**. A confidentiality agreement typically allows disclosure if demanded through proper legal proceedings. However, notice of the demand for disclosure, and possibly the requirement of opinion of buyer's counsel that no injunctive relief is available to protect the information may be included in the agreement.

10. **Noncontact/Nonsolicitation — Employees**. The buyer will want to interview the company's employees. While desirable, and even essential from a buyer's standpoint, it may cause problems for the seller. First, it may alert employees that a potential acquisition is underway, causing morale concerns or resignations. Second, the buyer may try to hire the seller's employees, in the event the transaction fails to be completed. A seller will want to limit the agreement to interview key employees and provide for non-solicitation of employees.

11. **Remedies**. Usually, an injunction is the company's best remedy. A provision waiving the obligation of bond is also important for clearing the way to an injunctive relief.

C. LETTERS OF INTENT

Not only do letters of intent have a psychological effect on subsequent negotiations; they serve certain specific purposes, including:

- Identifying issues;
- Clarifying the terms of the transaction; and
- Setting forth binding terms.

Letters of intent vary both in style and substance according to the nature and size of the proposed transaction. Because the buyer is usually the one making the offer, buyer's counsel usually prepares the first draft, which is then reviewed and edited by the seller and its counsel.

1. **Parties**. The letter of intent should be signed by each entity (or person) who will be subject to any of its binding provisions, or, at a minimum, by persons in control. For example, if the buyer proposes to buy all the stock of a corporation that has multiple stockholders, all stockholders should also sign the letter of intent.

2. **Binding Versus Non-binding Letters**. Most letters of intent contain both non-binding and binding provisions. Absent clear expression of the intent of the parties to the contrary, a court may find a letter of intent binding if it includes the material provisions of an agreement. Thus, a letter of intent often clearly state what terms are binding and what terms are non-binding and subject to further negotiation.

3. **Usual and Customary Matters**. The letter of intent should also state that the obligations of the parties to close the transaction will be subject to certain conditions. This can be phrased in three basic ways:

- The binding agreement "will contain the usual and customary representations, warranties, covenants, conditions, and other terms and provisions for transactions of this nature;"
- List the principal representations, warranties, covenants, and conditions that will be required; or
- The binding agreement "will contain such representations, warranties, covenants, conditions, and other terms and provisions as to which the parties shall agree."

The first two instances imply the substance of the agreement and the third is open-ended. A party who is more anxious to close the transaction will want either of the first two and a party who wants more flexibility will want the last example. Depending on the imagination and skill of the lawyer drafting the letter of intent and the sensitivities and concerns of the parties, these points will be more or less noticeable and more or less heavily negotiated.

4. **No-Shop Clause**. A no-shop clause prevents or limits the seller's right to find other buyers and basically grant the buyer an *exclusive* option to buy the company. The seller, and the directors of the seller may find this unacceptable and a potential breach of their fiduciary duties. The no-shop obligation may be qualified by the "fiduciary out," to protect directors from liability for breach of their fiduciary duties stemming from their failure to accept a better offer than the buyer's.

The buyer should try to draft any clause narrowly to the effect that subject only to the fiduciary duty of the directors under applicable law, as advised in writing by counsel, the seller will not solicit any offers for or participate in any discussions or negotiations or furnish any information to anyone with respect to a sale, merger, or other disposition of the business of the seller or any part thereof. This type of language would give the buyer the maximum possible security.

5. **Time Constraints**. A letter of intent should have a time limit. This encourages the parties to work towards finalizing purchase and sale agreements and complete remaining due diligence. If a party is uncertain about completing the transaction or perceives some value to delay, or simply does not want to be pressured, then a more open-ended letter of intent is typical.

6. **Public Announcements**. Some letters of intent include provisions for mutually agreed "joint" disclosures. A seller may wish to make an early public announcement to encourage other potential buyers. The buyer will wish to delay announcement as long as possible.

7. **Expenses and Termination**. Typically, each of the parties will bear its own expenses. The letter of intent should allow for termination by notice, or by a date certain, if a definitive agreement has not been signed. Certain provisions, e.g., confidentiality and non-competition provisions, may be drafted to survive the termination of the letter of intent.

D. DUE DILIGENCE

Due diligence refers to the investigation of the seller's business, finances and operations and is designed to provide the buyer with sufficient information about the seller's affairs. Initial due diligence typically focuses on the seller's financial statements and tax returns. Note: Seller's may also need to conduct due diligence on potential buyers, especially if the transaction contemplates "earnouts", seller financing, and post-closing obligations.

If the buyer's is satisfied with the seller's finances, further inquiry provides a more complete understanding of the seller's business. Issues uncovered in the due diligence process helps in drafting the purchase and sale agreement, including formulating the necessary representations, warranties and indemnities and the transactions disclosure schedules.

1. **Scope of Investigation**. It is important for the buyer to be familiar with the seller, its industry and the proposed transaction. However, the due diligence review is usually subject to time pressures. Nevertheless, inattention to the due diligence process could lead to litigation over matters which could have been resolved through a more detailed review prior to closing.

First priority is given to those issues which are so significant that they could be deal breakers. Deal breaker issues can include the following:

- Third-party restrictions, including change of control provisions contained in leases, licenses, credit agreements and customer or supplier agreements.

- Previously undisclosed material liabilities, including environmental liabilities, unfunded pension liabilities, tax liabilities, or potential liability claims due to product liability and/or professional malpractice.

2. **Problem Areas**. When dealing with the acquisition of a private company, buyers are often faced with inadequate records. This may lead to the buyer relying on the purchase and sale agreement's representations, warranties and indemnities. Other options will include purchase price earnouts, deferred payment of purchase price with a right of setoff, or an escrow of part of the purchase priced.

There may be justified reluctance in conducting extensive due diligence, because of the purchase price or the assets involved in the sale. For example, if the sale is of a single piece of equipment, reduced due diligence may be understandable, provided that the buyer obtained adequate assurances that the seller has the power and authority to sell the asset and the asset is unencumbered.

However, limiting the due diligence investigation to only those assets that are transferred is risky in the event there are seller liabilities including unfunded employment obligations, IRS or state tax liens, and environmental problems.

3. **Due Diligence — Representing the Seller**. Counsel for the seller will also face due diligence responsibilities. The seller's review of the buyer will enable the seller to protect itself by preparing disclosure schedules and will allow the seller to ascertain whether the buyer is adequately funded to close the purchase under the terms and conditions as outlined in the purchase or to complete its financial obligations if payments are to be funded over time.

4. **Third Party Inquiry**. Besides the inquiries addressed to the company, counsel should undertake independent verifications of certain facts, usually by checking with public agencies and other third parties. These inquiries should usually be made only after advising the company. Examples include:

i. Articles of Incorporation. The most recent articles of incorporation of Washington corporations can be obtained from the Secretary of State Corporations Division. Foreign corporations' articles can be obtained from their local jurisdiction.

ii. Good Standing Certificates. The good standing of a domestic or foreign corporation doing business in Washington can be verified with the Secretary of State, Corporations Division; foreign corporations and the qualification of any corporation to do business in other jurisdictions should be checked with comparable authorities.

iii. <u>UCC Searches</u>. A search of filing under the Uniform Commercial Code should be conducted in appropriate jurisdictions. Searches of UCC filings, liens and judgments may be made through the Department of Licensing and through county searches. Typically, a search service is used to perform such searches.

iv. <u>Real Property</u>. Title to real property should be checked, usually through a preliminary title report from a title company. The report should indicate the title company's willingness to insure good title, subject to the exceptions noted in the report. In reviewing these exceptions, lawyers should not rely on the summary but should request and review the actual recorded documents. Title insurance is advisable, and zoning, including any variances, should be checked with local zoning agencies. Environmental review of properties is critical, and an environmental test firm should be employed to perform preliminary phase 1 and more extensive reviews of any potential purchase or lease of real property.

v. <u>Patent and Trademark Searches</u>. Any significant patent or trademark registrations should be confirmed by appropriate searches with the Patent and Trademark Office. Although copies of issued patents, searches of assignments, and the status of the payment of maintenance fees can be checked directly with the Patent Office or through a commercial service, if the intellectual property is significant, the use of patent or trademark counsel is advised, especially to help evaluate the scope and value of patents and the strength of trademarks.

vi. <u>Permits</u>. When appropriate and possible, required or desirable government permits and licenses (and their transferability) should be verified with the agency involved.

vii. <u>Estoppel Certificates</u>. For particularly significant contracts, leases, loan agreements, accounts receivable, and purchase orders, it may sometimes be wise to get a certificate from the other party to the contract covering the amount of the debt or other obligation and any known defaults.

viii. <u>Litigation Indexes</u>. Washington (on a county-by-county basis) and federal courts maintain litigation indexes that can be reviewed to verify any pending lawsuits against or by the company or its principals.

ix. <u>Opinions</u>. Certain legal matters (such as due corporation, authorization of agreement) are traditionally verified through the opinion of counsel. (As with representations and warranties, however, such opinions are not substitutes for due diligence). Opinions can easily be overused; counsel are not insurance companies. In particular, factual matters are rarely appropriate for opinions.

x. <u>Financial and Accounting</u>. All financial statements and tax returns should be examined closely. An examination of the seller's financial statements should reveal the nature and extent of the seller's obligations, the structure of its ownership, and other items which may be important to evaluate the purchase. The tax returns and financial statements should also be reviewed for consistency and for potential problem tax audit areas.

xi. Third Party Contracts. The buyer should review the seller's contracts and agreements with third parties. A review is critical to determine the seller's commitments to other entities. In addition, it is important to ascertain whether such contracts may be transferred by the seller to the buyer. It is especially important to obtain copies of all contracts or agreements that will be transferred, so that the necessity for obtaining consent be reviewed and requested. Following is a brief list of contracts and special issues regarding such contracts:

- Customer Contracts. Not only should these contracts be reviewed but the buyer should meet with key customers as soon as possible to establish a good working relationship.

- Leases. Any real property and personal property leases need to be reviewed to determine if consent to assignment is required and whether the seller is in default under any provision of any lease.

- Supplier Contracts. If the business depends upon material or other supply contracts, such contracts should be reviewed carefully to ensure that the supplier is not only obligated to continue supplying the purchaser, but the supplier is in good financial health and will continue to supply the product on the same or similar terms and conditions.

- Employment Contracts. It is critical to ascertain whether the buyer will be obligated under any long-term contracts with employees and whether any key employees are subject to either long term agreements or non-competes.

- Labor Contracts. The buyer needs to review all pension and profit sharing plans, retirement plans, stock purchase plans, etc. and make sure such plans are funded.

- Loan Agreements. Most likely any loan agreements entered into by the seller will require lender approval before there is any assignment or release. It is also critical that any lenders be involved early on in the discussions, to prevent delay at closing.

- Insurance. Seller's insurance policy should be reviewed carefully to ensure that coverage for any act is adequate and there will not be any gaps in coverage.

E. VALUATION ISSUES

1. **Introduction**. The objective in valuing any business entity is to determine its fair market value. The fair market value of a business is usually defined as the price at which the business would change hands between a willing buyer and willing seller, neither being under a compulsion to buy or sell and both having reasonable knowledge of the relevant facts.

In most industries there are formulas which can be used to establish a rough value for the business. One can usually assume that a business is worth the value of its assets, plus a premium for goodwill when earnings are sufficiently high. From the IRS's view, the beginning point for any business valuation is Rev. Rul. 59-60 , which is the IRS's general guideline in valuing closely held stock for estate and gift tax purposes, and which lists eight factors to consider in valuing a business. Also of considerable concern is that some methods of business valuations do not take into consideration why the business is being sold. Therefore, some methods of formula valuation lack considerations for potential growth and the financial terms of the purchase.

2. **Considerations**.

i. Type of Business. In any valuation the nature and the history of the company to be valued is important. The industry within which the company operates will influence the weight accorded the various approaches to valuation and may furnish comparable companies against which the company's value is measured.

ii. Economic Outlook. The value of a business must be viewed in the context of how the financial markets view the economy. Past fluctuations in a company's costs and earnings may be explained by reference to the national or local economy, and the company's future potential may increase, or decrease, depending on the outlook for the economy as a whole.

iii. Book Value of Company. Book value is the historical or accounting value of the business's assets over its liabilities. Special situations, however, can have a dramatic effect in enhancing book value as a fair market value indicator. Such might be the case where a liquidation is in process or is imminent.

Where book value is used, adjustments to historical book value are routinely required. Typical adjustments might include adjusting fixed assets to fair market value, adjusting inventory for last-in-first-out (LIFO) reserves or correcting excess depreciation on assets. The resulting figure is referred to as the company's "adjusted book value".

iv. Earnings Capacity of the Company. Analyzing the earning power of a company engaged in selling products or services to the public is critical to determine its fair value. Future returns are of primary interest to the investor. Past earnings are often indicators of future earnings. However, in determining future earning power by reference to past earnings, several points need to be examined:

- Number of Past Years Taken Into Account. Generally, five or more years of prior earnings should be used in the analysis. If the company has not been in business for five years or its business has substantially changed in that time, a shorter period may be all that is available.

- Earnings Trends. A marked trend in earnings, either upward or downward, is important. If earnings are trending upward over a five-year period, for example, it may be proper to assign mathematically greater weight to the most recent year's earnings using a "weighted average" approach. If there is no definite trend in earnings, the business may be "cyclical", and a single average of the five year's earnings may be the best indicator of the companies earning potential.

- <u>Adjustment For Nonoperating Assets and Nonrecurring Events</u>. It is necessary to adjust the company's earnings by removing nonrecurring factors, such as unusual capital gains. In addition, income from substantial non-operating assets should be separated from the operating net income because different rates of return are applicable to the two income sources.

- <u>Price/Earnings Ratio</u>. Once the future earnings power of a company has been computed, the next step is to find the appropriate multiple which an investor will pay for those earnings. This earnings multiplier is the reciprocal of the correct "capitalization rate," and is called a price to earnings or "P/E ratio." The riskier the investment is, the higher the capitalization rate (and the lower the value of the company).

v. <u>Dividend Paying Capacity</u>. Investors in public companies often look at the company's dividend history. However, in the case of closely held corporations, which usually do not pay dividends, the actual dividend payment may be less than the ability of the company to actually pay dividends. Recognition of this fact has resulted in emphasis being placed on dividend paying capacity.

vi. <u>Whether Company Has Goodwill or Other Intangibles</u>. Goodwill can be defined as the excess of earnings over and above a fair rate of return on the company's net tangible assets. Demonstrated earning power is the primary evidence of goodwill. On the other hand, goodwill or other intangible value may be present in an enterprise, even though a series of loss years precedes the valuation date. In such a case, resorting to other formula-based valuations may be helpful and even necessary to properly value the company.

vii. <u>Sales of the Stock of the Subject Company</u>. In addition to factors relating to the financial condition of the company, such as earnings capacity, book value, dividend paying capacity and the companies goodwill or intangible value, previously sales of stock, valuation of stock option grants, or gifts of stock may also reveal "valuations" of the business.

viii. <u>Market Price of Stocks of Corporation Engaged in Same or Similar Lines of Business</u>. If similar company data is available, it can be helpful in comparing company values. However, it is often difficult to obtain good comparable data. Brokers and industry experts often have data which can be helpful. This is particularly true in sales of medical and dental practices.

3. **Alternative Approaches to Valuation**. Most valuations fall into two general categories (1) asset approaches and (2) valuations based on earnings.

i. <u>Adjusted Book Value</u>. The adjusted book value of a company is computed by taking the book value of the business (which is historically the assets less liabilities, booked at cost) and adjusting for the fair market value of hard assets, including excess depreciation, and other deceptive items such as LIFO inventory reserves.

ADJUSTED BOOK VALUE METHOD
Assets – Liabilities
+/- adj FMV of assets
- excess depreciation
+/- other adjustments (LIFO, etc.)
= Adjusted book value

ii. Comparable Price. The comparable price method requires an assumption that the values of other companies are comparable to the business being valued. This method relates the price of the business to earnings, book value, revenues, dividends and cash flow multiples of public companies. In order to use this method, at least three comparable companies should be found. Finding comparables is frequently a problem and the comparable price method is likely not appropriate in many circumstances. Once you have found comparables, the P/E or price to earnings ratio is used to compute the value.

COMPARABLE PRICE METHOD
Net income (subject company) x P/E ratio = Valuation (industry)

iii. Excess Earnings. The excess earnings method is based on the theory that the value of net tangible assets plus the capitalized value of excess earnings (the goodwill factor) equals the value of the business. The computation starts with the same net tangible assets computed in the adjusted book value method discussed above.

The next adjustment is to remove from earnings all "unusual" items. This will generally include items such as investment income (interest, dividends, etc.), which are derived from other than operations. This number arrived at is called the "adjusted earnings."

The amount that is considered "normal earnings" based on the industry standards is then subtracted from the adjusted earnings resulting in "excess earnings." This amount is then capitalized using a capitalization rate reflective of industry risk and results in "goodwill" which is then added to the adjusted book value for the total value of the business.

EXCESS EARNING METHOD
Earnings - Earnings not based on operations = Adjusted Earnings - Normal Earnings (from industry) = Excess Earnings ÷ by capitalization rate = value of excess earnings + value of adjusted assets = Total Value

iv. Formula Approach to Valuation. Often the valuation of a company is based on rule of thumb multiples of net revenue and owners' cash flow. The basic premise of using a formula approach is that such formulas are derived from actual market transactions and thus are in tune with a particular industry. If a particular industry has strong gross margins, predictable volume growth and moderate changes in generating costs, formulas may be a quick and efficient way to value a business. However, formulas are only general indicators of industry value and adjustments should still be made to account for the particular company's revenue, assets, and special conditions.

F. SUCCESSOR LIABILITY ISSUES

1. **Introduction**. When there is a merger or stock purchase, the buyer assumes all of the liabilities of the seller. Generally, an asset purchase is structured so that the buyer will not assume any liabilities of the seller, except for those obligations assumed by the buyer. Nevertheless, an asset acquisition may result in the liabilities being enforced against the buyer under a number of theories.

As a practical matter, successor liability can result in a simple acquisition of assets regardless of any contrary provisions in the asset purchase agreement. In addition, the buyer may be the only deep pocket able to satisfy seller's pre-sale liabilities. Therefore, the likelihood of litigation based upon these theories is increased in the event the seller goes out of business after the sale.

2. **General Rule — Asset Acquisition**. As a general rule, the buyer of assets of a corporation does not assume the selling corporation's pre-existing liabilities and obligations. The general rule of nonliability is based on the premise that "a sale of corporate assets transfers an interest separable from the corporate entity and does not result in a transfer of unbargained for liabilities from the seller to the purchaser."

The exceptions to non-liability include: (1) the purchaser expressly or impliedly agrees to assume liability; (2) the purchase is a de facto merger or consolidation; (3) the purchaser is a mere continuation of the seller; or (4) the transfer of assets is for the fraudulent purpose of escaping liability. The four exceptions to the general rule were developed "to protect the rights of commercial creditors and dissenting shareholders following corporate acquisitions."

3. **Purchaser Expressly or Impliedly Agrees to Assume Liability**. In order that a promise may be implied on the part of a corporation, to pay the debts of another corporation, the conduct or representations relied upon must show such an intention. The presence of such an intention depends on the facts and circumstances of each case.

One of the factors to be considered is the effect of the transfer upon creditors of the predecessor corporation. Admissions of liability on the part of officers or other spokesmen of the successor corporation are also considered in determining whether implied liability exists. However, the mere fact that the new corporation has voluntarily paid some of the debts of the old corporation is no ground for inferring that it assumed the latter's debts.

4. **Purchase is a De Facto Merger or Consolidation**. A de facto consolidation or merger takes place when two or more corporations are joined such as to result in the absorption of one by the other, or the creation of a new corporation. It occurs when the consideration flowing to the selling corporation is shares of the purchasing corporation's stock, as opposed to cash. The theory behind the requirement of a stock transfer is that the shareholders of the seller corporation retain an interest in the transferred business.

5. **Mere Continuation of Seller**. The mere continuation theory is designed to prevent the corporation from escaping liability "by merely changing hats." To prevail on the theory of "mere continuation" proof of at least two elements is required. The first element is "a common identity of the officers, directors, and stockholders in the selling and purchasing companies." The second element is "the insufficiency of the consideration running to the seller corporation in light of the assets being sold."

6. **Transfer of Assets is For the Fraudulent Purpose of Escaping Liability**. A successor corporation may be liable for the obligations of its predecessor if the transfer of assets is for the fraudulent purpose of escaping liability. However, where a corporation receives in good faith a transfer of the assets of another corporation, and pays the latter full consideration, the transfer is not fraudulent, and in such case, the creditors cannot hold the purchasing corporation from the obligations of the other, nor can they have the transfer set aside, or the property subjected to their claims. The fact that the purchasing company knew that the selling company was insolvent does not necessarily render the purchase fraudulent, so as to make the purchaser liable for the debts of the seller.

7. **Product Line Theory**. A buyer that acquires a manufacturing business and continues the output of its line of products assumes strict tort liability for defects in units of the same product line previously manufactured and/or distributed. Considerations favoring continued protection for injured users of defective products include the following:

i. the availability to plaintiff of any adequate remedy against the seller,

ii. the availability to the buyer of the knowledge necessary for gauging the risks of injury from previously manufactured products, together with the opportunity to provide for meeting the cost arising from those risks by spreading it among current purchasers of the product line; and

iii. the fact that the goodwill transferred to and enjoyed by the buyer could not have been enjoyed by seller without the burden of liability for defects in products sold.

A court must analyze the following in determining product liability:

i. whether the transferee has acquired substantially all the transferor's assets, leaving no more than a mere corporate shell;

ii. whether the transferee is holding itself out to the general public as a continuation of the transferor by producing the same product line under a similar name; and

iii. whether the transferee is benefiting from the goodwill of the transferor.

The buyer must structure the transaction to avoid at least one of the above three elements. Alternatively, investigation of the potential claims and appropriate reserves must be established to protect the buyer from liability. The buyer may also wish to limit liability by purchasing the business through a subsidiary corporation. Finally, the buyer may wish to limit liability through a claims made insurance policy.

8. **Environmental Claims**. Liability for damages resulting from a discharge of hazardous substances by seller has been imposed upon asset purchasers.

9. **Employment**. As asset purchaser may be held liable to pay the seller's employees back pay damages for unfair labor practices committed by the predecessor or to rehire former employees unlawfully discharged by the predecessor. Whether a new employer is a "successor" is determined by whether there is a continuity of the work force (whether the seller's employees comprise a majority of the new employer's work force when a "substantial and representative complement" of employees have been hired by the new employer). The National Labor Relations Board has considered the following factors:

i. The hiatus in the resumption of operations;

ii. Location of new entity;

iii. Supervisors/management changes;

iv. Customer/market carryover; and

v. Scale of operations, products, methods of production.

10. **Washington Department of Revenue Successor Liability**. RCW 82.04.180 defines a successor as:

- *Any person receiving more than 50% of fair market value of the tangible or intangible assets of the taxpayer;*

- *Any surviving corporation of a statutory merger; or*

- *Any person obligated to fulfill the terms of a contract as a surety or guarantor of a defaulting contractor, in which case the person is deemed a successor only to the tax liability arising out of that contract.*

A taxpayer who quits business, sells out, or exchanges or otherwise disposes of his or her business or stock of goods, must make a return of tax within ten (10) days thereafter. Any successor is also liable for the full amount of all sales or other excise taxes (including B&O) owed, but unpaid, by the predecessor

The Department of Revenue allows a successor to avoid liability for any state business and occupation or sales/use tax found to be due from the seller if:

- The successor provides a written notice of the acquisition to the Department of Revenue; and

- Within six months of receiving the notice, the Department has not issued a tax assessment against the seller and mailed a copy of a notice of tax due to the successor.

11. **Department of Labor and Industries Successorship Liability Provisions**. RCW 51.16.200 imposes successor liability on the purchaser for unpaid taxes due the Department of Labor and Industries for industrial insurance premiums of a predecessor who quits business or sells a major portion of its assets or inventory. This successor liability statute is virtually identical to RCW 82.32.140, providing the state the same right to collect unpaid industrial insurance premiums from a successor.

There is no comparable successor liability provision for unpaid claims owed to the Department of Employment Security for the employment compensation contributions of a defaulting employer quitting business. A buyer should also give notice to the Department of Labor and Industries of any purchase.

12. **Ensuring No Hidden Taxes**. A buyer should obtain a tax status letter from the Department of Revenue, the Department of Labor and Industries and Employment Security within one to two weeks prior to closing. The seller can apply directly to the departments or a signed authorization should be obtained from the seller, so the buyer can obtain these letters.

The response letters will state only whether all required returns have been filed and whether all taxes shown on the filed returns have been paid. These letters are not final tax clearances and do not certify that no additional taxes are due. Therefore, the buyer should also review the seller's prior filed returns.

Audits can be conducted on any of the filed returns during the open period of the statute of limitations on such returns resulting in an additional assessment, or there could be some problem with regard to filing of the final returns of the seller and/or payment of tax, including payment of the sales or use tax on the sale of the assets. Any of these eventualities could result in successorship liability being imposed on the purchaser for unpaid taxes, therefore, the need for the tax clearance letter, indemnity and holdback provisions and proper due diligence.

G. STATE AND LOCAL TAX CONSIDERATIONS

Three main taxes are imposed in Washington:

1. Retail Sales Tax;
2. Business and Occupation Tax; and
3. Real Estate Excise Tax.

The Retail Sales tax applies to every retail sale of tangible personal property in the State. RCW 82.08.050. The definition of retail sale is broad. The Business and Occupation tax is imposed on persons for the act or privilege of engaging in business. The Real Estate Excise tax is imposed on each sale of real property in Washington.

1. **Sale of Stock**. There is no Business and Occupation ("B&O") or Retail Sales tax due on the sale of stock or other intangible business interest. The sale of stock is not "engaging in business activity" for B&O tax purposes and it is not the sale of tangible personal property for sales/use tax purposes.

2. **Asset Sale**.

i. <u>B&O Tax</u>. Generally, the B&O tax does not apply to the sale of substantially all the assets of a business other than its inventory. B&O tax is not imposed on a "casual or isolated sale," which is the typical business sale. RCW 82.04.040 defines a "casual or isolated sale" as "a sale by a person who is not engaged in the business of selling the type of property involved."

ii. <u>Asset Sale — Retail Sales Tax</u>. The sale of tangible personal property is subject to retail sales tax, unless the sale is otherwise specifically exempted. RCW 82.08.020.

- Resale Exception. The sale of property to be used by the purchaser for resale, or to be added to or consumed in the production of another product, is exempt from the retail sales tax. Many businesses have inventory type property held for resale or raw materials intended to be incorporated in a product. When such property is sold in bulk as part of the sale of a business' assets, that portion of the sale is not subject to the retail sales tax, because it does not fit within the definition of retail sale.

The seller has the burden to prove that any property was purchased for resale. RCW 82.04.470. WAC 458-20-102 allows the seller to rely on a resale certificate obtained in good faith from Buyer.

The retail sales tax does not apply to the portion of an asset sale consisting of intangible property such as customer lists, goodwill, patents, copyrights, licenses, trademarks, etc.

3. **Payment of Sales Tax**. Liability for payment of the sales tax on the sale of a business' assets rests upon both seller and purchaser. RCW 82.08.50. Where the buyer fails to pay tax for whatever reason, the state may proceed directly against the seller for collection of the tax.

4. **Asset Sale/Use Tax**. Use tax is imposed on the privilege of using within this state any article of tangible personal property purchased at retail, or acquired by lease, gift, repossession or bailment, or extracted, manufactured or produced by the person using the same. RCW 82.12.020. WAC 458-20-178 implements the statutory provisions governing the imposition of use taxes. There are many narrow, specific exemptions to the use tax set forth at RCW 82.12.0251 through 82.12.038. As with the sales tax, these exemptions should be consulted in the event one does fit the buyer's use.

5. **Calculating the Amount of the Sales/Use Tax**. Both the sales and use taxes are calculated by multiplying the tax rate applicable in the local jurisdiction in which the sale or first use occurs by "the value" of the property sold. WAC 458.20.107.

When a business sells its assets, the sales or use tax is reported based on the portion of the purchase price allocated by the parties to the property subject to tax. When the assets of a business are sold, typically the sale agreement states how the buyer and seller have allocated the total purchase price among the assets being sold.

The allocation is made between real property (if any) and categories of tangible personal property, as well as intangible property such as goodwill, customer lists, licenses, patents, and franchises. The Department of Revenue has the right to challenge the parties' allocations.

6. **Time of Payment for Sales and Use Taxes**. For most transactions, taxes will be due following the normal reporting schedule for the type of taxes to be paid. When, however, a sale involves either a seller quitting business or an installment sale, special rules come into play.

i. Sales Tax. Sales tax payable on the sale of the tangible assets of a business is due on the seller's next regular reporting date after the date of the sale. For example, if a seller is on a monthly reporting schedule, the sales tax resulting from the sale of assets would be due on the 25th day of the month following the closing date of the sale. A small business might be on a quarterly or annual reporting schedule.

ii. Use Tax. Use tax, if it is paid in place of sales tax, is due on the 15th day of the month following the month of sale. Although technically sales tax, rather than use tax, is due on the sale of most business' assets, sales of business assets are frequently reported on use tax returns rather than sales tax returns. The due date for the tax and return is controlled by the form filed.

iii. Installment Sales. Many businesses are sold on installment, where the seller receives a certain amount of consideration as a down payment with a note from the purchaser for the remainder of the purchase price. The Department of Revenue has the authority to require the collection of taxes on installment sales or sale-type leases of personal property as the payments fall due. RCW 82.08.090. At closing of an installment sale of business assets, the full amount of the sales/use tax should be collected.

7. **Personal Property Tax**. Personal property tax in Washington is imposed on the fact of ownership of property and not on the occurrence of a transaction such as a sale. The sale of tangible personality used in a business moves the incidence of taxation from the seller to the buyer as of the date of closing.

Liability for payment of personal property tax is accelerated so it is due at the time of sale. County treasurers have the right to seize personal property on which taxes have been levied, but not paid, if that property is about to be sold or otherwise transferred. RCW 84.56.070 and 090. Of course, liability for any unpaid taxes runs with the property so the purchaser must assure that all taxes on the property are paid to assure no liens remain against the property.

Personal property taxes are paid in the current year based on ownership during the preceding year. Sellers and buyers of a business' assets must be concerned with apportioning not only the current year's personal property taxes, but the taxes which would normally be payable in the year following closing as well since those taxes relate to ownership during the year of closing. The sale agreement should provide for payment and proration of all personal property taxes as part of the closing.

8. **Application of Real Property Tax to an Asset Sale**. State law imposes tax on the ownership of real property as well. Where real property is one of the assets sold, the sale agreement routinely apportions real property taxes between the seller and buyer based on the number of days in the current year the property is owned by each. However, there is no acceleration of real property tax due upon sale, as there is with personal property tax.

Since an unpaid tax creates a lien on the property, the sale agreement should provide for adjustment and payment of the real property tax at closing. With real estate the main issue is to insure there are no delinquent taxes and that taxes for the year of closing are provided. A title report should reveal past due tax liens.

9. **Application of the Real Estate Excise Tax to an Asset Sale**. In Washington, a separate excise tax is imposed on the sale of real property. Ch. 82.45 RCW. If the business assets sold include real property, this tax will apply. In addition, if greater than fifty percent (50%) ownership in an entity is sold within a 36-month period, and the entity owns real estate, the real estate excise tax applies.

H. FEDERAL TAX CONSEQUENCES

1. **Introduction**. The tax consequences resulting from a business sale make tax planning critical. In a typical sale, the buyer desires to buy the seller's business based on the buyer's perceived value of the business. The seller also has a perceived "value" of the business. However, neither may contemplate how taxes will impact their net return.

There are many factors to consider in structuring the sale transaction, some not dependent on tax issues. For example, if the seller's goal is liquidity and diversity of investment, obtaining an equity interest in the buyer would be inconsistent and incompatible with Seller's goal. At the same time, the buyer may not wish to have the seller involved in the business. There may also be regulatory or licensing considerations or creditor concerns. All influence whether the transaction should be structured as an asset sale, a stock sale or some type of merger, independent of the tax consequences.

2. **Forms of Taxable Transactions**. Taxable transactions are treated for tax purposes such as either the sale and purchase of assets or the sale and purchase of stock.[1] In a taxable transaction, the selling party receiving consideration from the buyer will be taxed to the extent that the consideration received exceeds the tax basis of the transferred property (IRC § 1001). The buyer's basis for depreciation in the property received equals the total consideration paid (IRC § 1011-1012).

Generally, if the purchase price exceeds the seller's tax basis the seller will recognize gain. Although the seller suffers from tax recognition, the buyer benefits from the "stepped-up" basis on the property received. The rate of tax depends on both the character of the property sold and its holding period.

i. <u>Sale of Stock</u>. A sale of stock will result in gain or loss to the selling shareholder, measured by the difference between the seller's tax basis of the sold stock and the consideration received. As will be seen later, there are instances where stock sales, are in fact treated as asset acquisitions. The gain from the sale of stock may be long-term or short-term capital gain, depending on holding period of the stock. It is important to review the stock ledger to determine the holding period of all stock owned by the selling shareholder.

ii. <u>Sale of Assets</u>. A sale of assets will result in a tax to the entity. Depending on the type of entity, this may be an entity level tax, or a gain pass through to the owners.

- <u>Subchapter C Corporation</u>. A subchapter C corporation pays tax at the corporate level. Therefore, upon the sale of its assets, there is typically two levels of tax. First, upon the corporation sale, and second, if and when the shareholders liquidate their interest in the corporation. If the selling corporation is liquidated, a second tax will be imposed on the shareholders on the gain represented by the amount of the distribution that exceeds the shareholders' tax basis in their stock.

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[1] See generally, Phillips and Rothman, 770 T.M., Structuring Corporation Acquisitions – Tax Aspects.

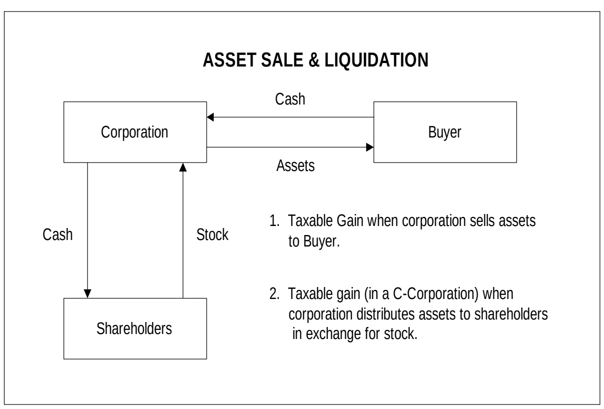
- Subchapter S Corporation. In a subchapter S corporation, the double tax problem is eliminated, since the gain on the asset sale is passed through to the individual shareholders, increasing the basis of their stock in the corporation.

- Twelve Month Liquidation. In instances where the corporation receives installment obligations upon the sale of its assets, the shareholders, however, are the real parties receiving the benefit of the note. IRC § 453 accelerates the gain on the distribution of an installment obligation. IRC § 331 though allows a corporation to dissolve or liquidate after a sale of its assets and receive capital gain treatment. § 331 basically states that if all the corporate assets are sold by the corporation, and thereafter distributions are made to shareholders in complete liquidation of their stock interest, the distributions are treated as an exchange.

The distributions of property are treated as exchanged if they are made within 12 months after the adoption of a plan of liquidation. The shareholders must adopt a plan of liquidation and a certified copy of the plan attached to Form 966 which must be filed with the IRS within 30 days of the majority vote.

iii. Section 338 Election. When a corporation (not an individual) purchases 80% or more of the stock of a target corporation, the deemed sale of assets rule in § 338 comes into play. Under § 338, the corporation making a qualified stock purchase can elect to treat the corporation whose stock is being purchased as having sold all of its assets on the acquisition date at fair market value. A qualified stock purchase is the purchase of at least 80% of the total voting power value of the target corporation during a 12-month acquisition period.

When this happens, the target corporation's tax year immediately ends. Its short tax return must recognize gain or loss on the deemed sale of its assets, even though the target corporation sold only its stock. Thus, the shareholders can be double taxed on the earnings and profits as dividends and as capital gain or loss on the disposition of their "stepped up basis" shareholdings. Nevertheless, one should be aware that a shareholder could pay higher taxes as a result of an IRC § 338 election, due to depreciation recapture, and other tax adjustments resulting from a § 338 election. Therefore, a "gross-up" clause should be insisted in any stock purchase agreement which provides for payment by the buyer to the seller of additional sums due to any tax increase.



iv. Purchase Price Allocations. In an asset sale, each asset sold is treated as being sold separately. The purchase price is allocated among assets using the "residual method."[2] The rationale for IRC § 1060 is that consistent positions should be taken by both buyer and seller. Regulation 1.1060-1T(d) prescribes five specific allocation classes:

Class I Cash, bank accounts, and equivalents.

Class II Marketable securities, foreign currency, certificates of deposit, US bonds, etc.

Class III All other tangible and intangible assets except Classes IV and V.

Class IV All § 197 intangibles except Class V.

Class V Goodwill and going concern value.

Classes III, IV and V are typically applicable in small business bulk sales. Class III assets consist primarily of tangible items such as land, structures, furniture, fixtures, equipment, accounts receivable, etc. Class IV assets consist primarily of covenant not to compete and other separable intangibles. Whatever is left over is Class V. The buyers and seller may agree in writing to allocations of part or all of the consideration and the value of the assets transferred. The buyer and seller must both file IRS Form 8594 upon the transfer of a business to which goodwill could attach.

v. Section 197 Intangibles. IRC § 197 provides in subsection (a):

A taxpayer shall be entitled to an amortization deduction with respect to any amortizable § 197 intangible. The amount of such deduction shall be determined by amortizing the adjusted basis (for purposes of a determining gain) of such intangible ratably over the 15-year period beginning with the month in which the intangible was acquired.

IRC § 197 provides that the purchase price allocated to certain intangibles, such as goodwill or going concern value, may be amortized over a 15-year period. IRC § 197 intangibles include: (1) goodwill; (2) going concern value; (3) certain types of intangible property relating to workforce, information base, etc.; (4) licenses and permits; (5) covenants not to compete; and (6) franchise and trademarks.[3] The aforementioned listing is a fairly all-inclusive checklist of most everything that constitutes goodwill. Note however that patents and copyrights are not included in the list. Because patents and copyrights have ascertainable useful lives, separate from goodwill, they may be depreciated.

It is important to note that all of the items mentioned in IRC § 197 are treated as inseparable from goodwill. If one or more of the items is disposed of, wastes away, or fails to meet its expectations in less than 15 years, only the tax basis in the amortizable account is adjusted.

[2] See IRC §1060.

[3] See generally, 209 T.M., Purchase Price Allocations and Amortization of Intangibles.

Critical in the purchase of a business is whether one can pay a former owner for "consulting services" over a shorter period of time and avoid the 15-year mandatory write off period for covenants not to compete. It should be noted that arrangements similar to covenants not to compete, such as compensation of rental paid to the former owner for his continued services or the continued use of his property, are also treated as a § 197 intangible.

If there is a disposition of any amortizable § 197 intangible acquired in a transaction and any one or more other amortizable § 197 intangibles acquired in such transaction are retained,

> . . . no loss shall be recognized by reason of such disposition (or such worthlessness), and
> appropriate adjustments to the adjusted basis of such retained intangibles shall be made for any loss not recognized.

Thus, for example an acquirer who purchases the customer list or other database may not claim a loss deduction as customers cancel or terminate subscriptions or services.

Exclusions from Section 197. The underlying rationale of § 197 is its focus on acquisitions which are essential to the continuation of the business after its ownership change. There are certain exclusions enumerated in subsection § 197(e). They are:

1. Financial interests in a corporation, partnership, trust or estate.

2. Interest in certain financial contracts.

3. Interest in land or leases thereof.

4. Certain computer software.

5. Certain separately acquired rights and interest.

6. Interest under existing leases of tangible property.

7. Interest under existing indebtedness.

8. Sports franchises.

9. Residential mortgage servicing rights.

10. Corporate organization and reorganization costs.

It should be noted that the computer software exception applies only if the software is not acquired in a transaction involving other assets constituting a trade or business. If acquired apart from the sale of an ongoing business, computer software is a tangible asset depreciated over five years, generally.

vi. Net Operating Loss. A company with a net operating loss may be an attractive candidate for purchase. However, there are limitations to the benefits of acquiring such loss. Generally, if the ownership of a loss corporation changes by more than 50% within a three-year period, loss carryover limitations are imposed. Under IRC §382, the post-acquisition loss is limited by the value of the "old" loss corporation multiplied by the long-term tax-exempt rate then in effect.

3. **Tax-Free Reorganization**. Tax-free corporate reorganizations are defined in IRC § 368. Generally, under IRC §§ 361 and 357, no gain or loss by a corporation is recognized if stock or securities in a corporation which is a "a party to a reorganization" are exchanged solely for stock or securities in that corporation or in another corporation which is "a party to a reorganization." Shareholders of the target, who, pursuant to the reorganization, exchange their stock for stock of another corporation will also not recognize any gain. IRC §§ 354, 356.

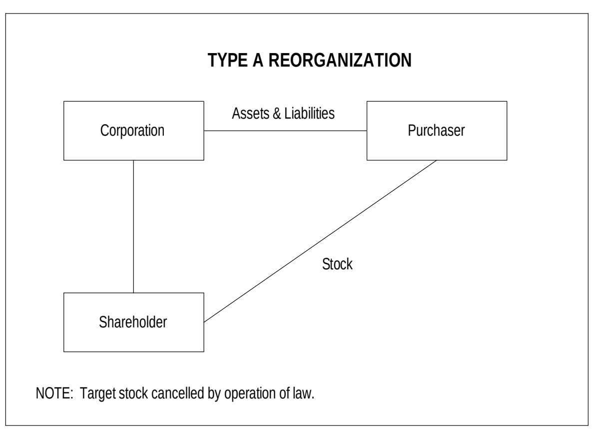
Gain will be recognized on any "boot" received (property that does not qualify for nonrecognition treatment) as if it were sold at its fair market value. The basis of stock and securities received in a reorganization is the same as the basis of the property transferred to the acquiring corporation, adjusted for any gain or loss recognized on the exchange and the value of any money or other property ("boot") received. IRC § 358(a).

A qualified "reorganization must fall within one of seven categories as follows:

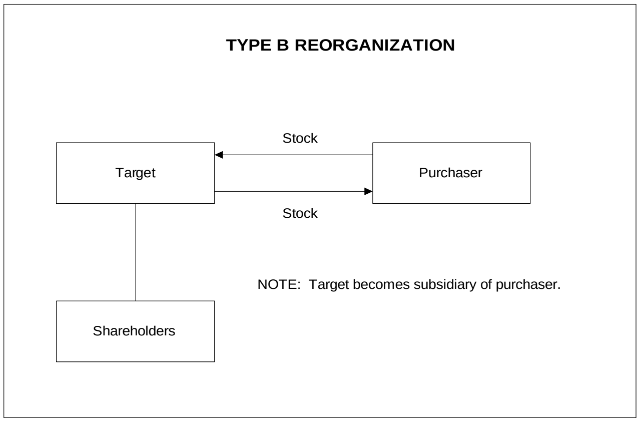
i. Types of Reorganization.

- Type A Reorganization. The type A reorganization is a statutory merger or consolidation. IRC § 368(a)(1)(A). Washington provides for the merger of corporations between either domestic or foreign corporations. RCW 23B.11 et. seq. In a statutory merger, two or more corporations are combined and only one of the corporations survives. The assets and liabilities of the disappearing corporations are transferred to the surviving corporation by operation of law.

Shareholders of the disappearing corporation receive stock in the surviving corporation in exchange for their stock in the disappearing corporation. The stock in the disappearing corporation is then canceled by operation of law. The advantages of an "A" merger is that it is relatively simple and less expensive then the other types of mergers. The disadvantage is that it is more difficult to pick and choose assets and liabilities to acquire.



- <u>Type B Reorganization</u>. The type B reorganization is a stock-for-stock exchange requiring that solely voting stock of the acquiring corporation be used for the acquisition and that the acquiring corporation, after the transaction, owns 80 percent of the acquired corporation's voting stock and 80 percent of all other classes of stock. IRC § 368(a)(1)(B). The acquiring corporation cannot use cash in the exchange or the reorganization becomes taxable. IRS Reg. § 1.368-2(c).



- <u>Type C Reorganization</u>. The type C reorganization is a stock for assets exchange, requiring the acquiring corporation to use its voting stock to purchase substantially all the selling corporation's properties. IRC § 368(a)(1)(C). In advance rulings, the Internal Revenue Service has interpreted "substantially all" to mean at least 90 percent of the corporation's net assets and at least 70 percent of its gross assets.[4]

A type C reorganization also requires that the acquired corporation distribute the buyer's stock received in the transaction, and any of its other retained properties, to its shareholders as part of the reorganization plan.[5] In addition, the target shareholders must, for some minimum period of time after the transaction, possess the benefits and risks of ownership and the discretion to retain or dispose of the acquirer's stock without restriction.[6]

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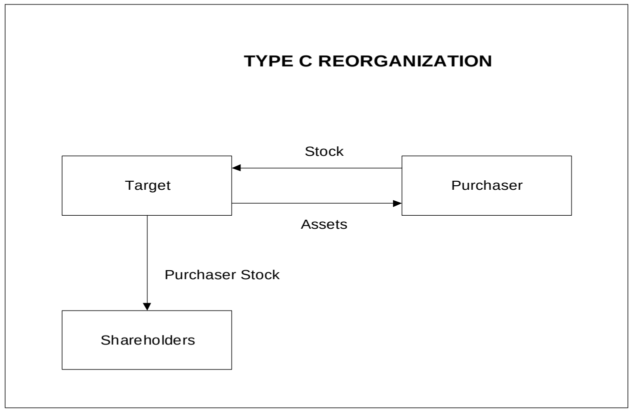
[4] Rev. Proc. 77-37, 1977-2 C.B. 568, as amplified by Rev. Proc. 86-42, 1986-2 C.B. 722.
[5] IRC § 368(a)(2)(G).
[6] Rev. Rul. 66-23, 1961-1 C.B. 67.



- Type D Reorganization. A type D reorganization is a transfer by a corporation of all or a part of its assets to another corporation if, immediately after the transfer, the transferor or one or more of its shareholders is in control of the corporation to which the assets are transferred. The D reorganization is basically as follows:

  - A transfer by a corporation of substantially all of its assets to a controlled corporation followed by a complete liquidation of the transferor corporation; and

  - A transfer by a corporation of a part of its assets to a controlled corporation, followed by a distribution of the controlled corporation's stock in a spin-off, split-off or split-up.

ii. Assumption of Liabilities. A release from liabilities assumed by a transferee or the disposition of property subject to liabilities in a reorganization is not "other property or money" received by the taxpayer and will not prevent the transaction from being tax free. IRC § 357. However, if the principle purpose of the assumption of liabilities is to avoid income tax, or the purpose is not a bona fide business purpose, the liability assumed is treated as other property or money. IRC § 357(b)(1). Note: if the liability assumed, or to which the property is subject exceed the total basis of all properties, the excess is treated as gain from a sale or exchange of a capital asset or a non-capital asset, depending on the nature of the encumbered asset.

iii. Additional Requirements for Reorganizations. Certain judicial and administrative requirements apply to corporate reorganizations. If the requirements are not met, the transaction will not be tax free reorganization.

- Continuity of Shareholders' Interest. "Tax-free" is premised on the continuity of the business enterprise in a combined form. Therefore, the successor corporation must continue the historic business of the transferor.[7] Only those transactions whereby shareholders continue to own an equity stake in the surviving entity qualify for tax-free treatment. Courts focus, then, on the character of the consideration received by the shareholders of the target.

[7] Reg. § 1.368-2(a); Rev. Rul. 79-434, 1979-2 C.B. 155; Halpert, Continuity of Business Enterprise Regulation Invigorates a Dormant Doctrine, NYU 40th Inst Fed Tax, Part 2 §§ 50.1-50.4 (1982).

Disposition of the stock received by target shareholders shortly after the merger may give rise to tax under the step-transaction doctrine.

- Valid Business Purpose. The transaction must have a valid business purpose.[8] Although the analysis is somewhat confusing, the business purpose requirement essentially means that "in substance" the merger must be other than for mere tax avoidance and have a valid business reason. Transactions between unrelated parties should not be suspect.

- Continuity of Business Enterprise. This focuses on the business of the surviving entity, rather than the consideration paid. The survivor must (a) continue line of business, or (b) use a significant portion of the target's business assets.

iv. Report of Sale of Business. The applicable form for a broker reporting a bulk sale of a business to the IRS is Form 1099-S. The official title of the form is "Proceeds from Real Estate Transactions." The instructions to Form 1099-S define "gross proceeds" as:

> any cash received or to be received . . . by or on behalf of the transferor, including the stated principal amount of a note payable to or for the benefit of the transferor. If the transferee assumes a liability of the transferor or takes the property subject to a liability, such liability is treated as cash and is includable as part of the gross proceeds. For a contingent payment transaction, include the maximum determinable proceeds . . . The maximum determinable proceeds means the greatest amount of gross proceeds possible if all the contingencies are satisfied . . . Do not reduce gross proceeds by any expenses paid by the transferor, such as sales commissions, deed preparation, advertising, and legal expenses.

v. IRS Form 4797. IRS Form 4797 is used to report the sale of assets not in the ordinary course of business. The official instructions to Form 4797 state that its purpose is to report the sale or exchange of trade or business property; depreciable and amortizable property; oil, gas, geothermal, or other mineral properties; and § 126 [farm] property; and the disposition of other noncapital assets. The official heading of the form is "Sales of Business Property."

The form is structured into gain and loss columns, with separate line entries for each asset or category of assets sold. Form 4797 instruction provides for the entering of gross proceeds from Form 1099 or a substitute statement. Form 8594, Asset Acquisition Statement, can be interpreted to be a substitute statement for purposes of reporting on Form 4797. However, Form 1099-S and Form 8594 should be consistent in its report of gross proceeds, Form 1099-S and total sales price, Form 8594. Inconsistencies may result in an IRS audit.

vi. Section 1231 Property. Section 1231 is property used in trade or business. For properties held more than one year, § 1231 is known as the capital gain, ordinary loss rule. If capital gains exceed losses, the net gain is treated as capital gain. However, when losses exceed

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[8] Gregory v. Helvering, (1935) 293 US 465; Reg. § 1.368-1(b)-(c).

gains, the loss is treated as ordinary loss. To take advantage of the capital gain, ordinary loss rule of § 1231, the property must be used in a trade or business.

This means property of a character which is subject to an allowance for depreciation, held for more than 1 year, and real property used in a trade or business, held for more than 1 year which is not inventory, held primarily for the sale of customers, or a copyright or similar property, held by the taxpayer whose personal efforts created such property. Therefore, goodwill, covenants not to compete, patents, licenses, etc., are treated as § 1231 property. When one sells a business, there is the potential for gain from disposition of recapture property. This means that if the business owner has previously depreciated certain property, upon the sale at gain of such property, the owner will have ordinary income. The primary classes of recapture property are as follows:

§ 1245. Depreciation of machinery and equipment.

§ 1250. Additional depreciation of buildings.

§ 1252. Conservation expenses: Farmland.

§ 1254. Intangible drilling and development costs.

§ 1255. Subsidy payments excluded from income.

I. CLOSING

Although the closing is oftentimes a time-consuming event, it should be simple with little or no controversy between the parties with the primary purpose being the execution and exchange of documents. Whether or not the Closing is a simple exchange of executed documents will depend in large part on the pre-preparation of the documents and the parties who will be signing at Closing.

1. **Pre-Closing Preparation**. The pre-closing preparation should include at a minimum the following:

i. A prior agreement on the allocation of responsibility among the parties for preparation of Closing documents.

ii. The exchange of all Closing and related documents and the negotiation of final changes to them, prior to the date of Closing.

iii. Prior arrangements for (i) the recording of real property transfers and issuance of title insurance simultaneous with the Closing, (ii) the arrangement for wire transfer of funds, (iii) the establishment of long-term escrows, including the terms under which escrow agents agree to act, and the apprising of the escrow agents of the timing and procedures for fund disbursements from escrow, (iv) documentation approving the transaction by all parties (i.e., Boards of Directors, Shareholders, Landlords, etc.), and (v) evidence that appropriate insurance will be in place as of the date of Closing to cover the assets.

iv. A pre-Closing conference to discuss and resolve all of the outstanding matters between the parties.

2. **The Closing**. The actual closing procedures should be conducted in accordance with the substance and intent of the provisions of the purchase and sale agreement, including, for example, whether a certificate is to be signed by the Seller reiterating the warranties and other agreements set forth in the purchase and sale documents at the time of closing. Such closing certificate (oftentimes referred to as a bring-down certificate) may be helpful for evidentiary purposes in the event of any future dispute, but more importantly, it serves to remind the parties once more of their obligations contained in the purchase agreement.

At the closing, the parties may be required to sign a number of original documents, including the following:

i. Deeds for all real estate.

ii. A bill of sale covering all personal property transferred in the transaction. It should be noted, the bill of sale may provide all of the property held by the Seller and associated with the business being sold, including, but not limited to, the assets shown on the attached Exhibit.

The bill of sale should also contain a provision requiring the Seller the execute any additional documents necessary to perfect the transfer. The Seller may want the bill of sale to acknowledge that the Buyer accepts the assets in an "as is" condition as of the date of Closing. Separate transfer documents will be necessary for certain assets including vehicles, airplanes, boats, trailers, etc.

iii. Assignment of all contract fights, accounts receivable, and similar intangible property rights.

iv. Separate assignment documents of all patents, licenses, trademarks, trade names, copyrights, trade dress and other similar rights.

v. Assignment of all lease rights including consents from landlords if required.

vi. Appropriate transfers of bank accounts and safe deposit boxes.

vii. Assignments of licenses (i.e., liquor licenses, meat licenses, cheese licenses, etc.) and other governmental authorizations, to the extent permitted by applicable laws and regulations.

viii. Execution and delivery of required promissory notes, security interests and UCC-1 financing statements if applicable.

ix. The assignment of all insurance policies, with the consent of the insurance carrier where required and allowed.

x. In the event the Buyer agrees to assume some of the Seller's liabilities and obligations, a separate assignment and assumption of liability of these documents should be signed by the Buyer and consented to by the third patty creditor.

xi. In the event of a stock transaction, the Seller must endorse and deliver to the Buyer the Stock Certificate evidencing ownership. In addition, in such transactions, the Seller will typically sign resignation of officers and directors, new banking resolutions and other specific corporate powers including the election of the new officers and directors.

3. **Post Closing Matters**.

i. <u>Filing of Security Agreements</u>. If seller is retaining for security purposes an interest in the property transferred, the seller must of course record mortgages, file financing statements, and check that a notation indicating the security interest has been made on certificates of title to motor vehicles.

For filing of security interests in copyrights; and in patents. For conflicts and overlap between these provisions and Article 9, see RCW 62A.9-104 and Comment 1 accompanying that section.

The place for filing the security interest under Article 9 depends on the nature of the collateral. In general, file with the Department of Licensing for personal property of the business except for fixtures. For fixtures, you must file with the county auditor in the county where the land is located. If there is a question whether collateral, such as an interest in leases, and mortgages are real or personal property, file under both Article 9 and RCW 65.08.

ii. Recording Title Documents.

- For deeds to real property, record all deeds with the county auditor and obtain supplementary title reports on real estate from title company. It may be necessary to work out a procedure with the title company that before the closing ends, the deeds are recorded, and the title reports issued.

- For motor vehicles, file signed certificate of registration transferring title with the Department of Licensing.

- For assignments of patents, trademarks, and copyrights, record as follows:

  - For patents, record with the U.S. Patent and Trademark Office within three months from the date of the assignment.

  - For Trademark, record the assignment of trademark with the Secretary of State for the State of Washington, and within three months with the U.S. Patent and Trademark Office.

  - Finally, for copyright, record with the United States Copyright Office within one month.

iii. Giving Notice of the Transaction. If a new partnership or proprietorship is being formed, the purchaser must file an assumed business name with the Department of Licensing. This will also be necessary if a corporation is to conduct a business under an assumed business name. The assignment of an assumed name also requires the filing of a certificate.[1] The seller may file a notice of cessation of doing business under the assumed name.

If a new corporation is being formed, ascertain the availability of the proposed corporate name with the Secretaries of State of the states in which the corporation is do business.[2]The name can be reserved in advance RCW 23B.04.020. If the buyer in an asset transaction is to use the corporate name of the seller, the seller must amend its Articles of Incorporation to change its name before the buyer may use the name. This should be done almost simultaneously.

iv. The Closing File. Finally, the parties and their advisors are well advised to prepare a Closing file containing all of the drafts of the agreements, an original or a copy of all signed documents, and a specific Closing memorandum outlining any adjustments and other

[1] RCW 19.80.010, 025.

[2] RCW 23B.04.010.

information that may be useful in the future for the purpose of interpreting the intent of the parties as conveyed in the documents.

Paul Tonella practices in Keller Rohrback's business and estate planning group, where he represents individuals, families and companies in corporate governance, mergers and acquisitions, real property transactions, and estate planning.

Paul began his over thirty-year legal career as a tax litigator where he combined his law background and accounting degree to defend his clients before the IRS and Washington Department of Revenue. Gradually, his practice evolved to include tax planning, and business and real estate transactions. He has spoken to numerous professional organizations on the legal issues facing today's business owner and family.

Paul represents a wide range of practice professionals (dentists, accountants, engineers), contractors, manufacturers, distributors, and real estate developers in their legal needs. He has served and advised boards of directors of non-profit, charitable and for-profit companies. Whether it is a specific transaction, or long-range planning, Paul brings his energy, knowledge, and experience to his clients, to meet and exceed their expectations.

When he is not practicing law, Paul is an avid outdoorsman, and can be found hiking, skiing and kayaking throughout Washington's wilderness and waters.