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Some Fundamentals of Corporate Acquisitions

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SOME FUNDAMENTALS OF CORPORATE ACQUISITIONS

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When a businessman decides to acquire the business of another corporation, he thinks in terms of buying a business for a consideration having a specific dollar value. Unless he is very sophisticated in methods of making corporate acquisitions, the businessman usually leaves what he believes to be the "details" of the transaction to his lawyers. In today's climate of complex tax regulations and imaginative financing techniques, the "details" of a corporate acquisition — the architecture of the transaction — may well determine the success or failure of the transaction.

Reduced to its simplest terms a corporate acquisition rests on three principal points:

First, What is to be acquired?

Second, What is the consideration to be paid?

Third, How is this consideration to be paid?

Each of these points requires considerable embellishment, and when combined with the other points the resulting transaction is often a complex, multi-faceted solution to a problem to which there are unlimited possibilities. The final form of the acquisition is usually the result of lengthy negotiations covering numerous points.

WHAT IS TO BE ACQUIRED? ASSETS OR STOCK?

When acquiring a corporation's business, the acquisition may be of all or a part of the assets of that corporation or all or a part of the corporation's stock. The stock will be acquired from the individual stockholders. In addition, the acquisition may be in the form of a merger or consolidation

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consummated pursuant to the statutory requirements of the state of incorporation of the constituent corporations.

NON-TAX CONSIDERATIONS OF ACQUIRING STOCK VS. ASSETS[1]

The acquisition of the stock of an acquired corporation directly from its stockholders is the quickest, easiest and simplest form of transaction because of the ease with which corporate stock may be transferred as compared to the transfer of assets. Instead of preparing, executing, acknowledging and recording documents of conveyance such as deeds covering real estate, assignments of leased property, patents, contract rights and business agreements, and bills of sale covering personal property, the transfer of stock is made by a simple endorsement of the assignment form on the back of the stock certificate.

With the acquisition of stock the corporation continues without disturbance or interruption. This can be both good and bad. It is good in that there is no necessity for new contracts with labor unions, employees, customers or suppliers. In some cases new contracts or consents to the assignment of existing contracts are impossible to obtain. It is bad in that the obligations and liabilities of the corporation continue and are inherited by the purchaser who, in the absence of a complete and enforceable indemnity from the seller, may have inadvertently and without knowledge assumed unexpected and unknown liabilities for back taxes, contractual obligations, damages arising out of a tort or even pending litigation.

The fear of unknown liabilities is often the basis for very serious negotiations between buyer and seller. The buyer, aware of possible undisclosed or unknown liabilities,

[1] Stark, *Non-Income Aspects of Corporate Reorganizations: A Check List of the Issues and Problems Involved,* N.Y.U. 24TH INST. ON FED. TAX 1085 (1966); Weithorn & Elder, *Buyer's and Seller's Points in Sale of Corporate Business: An Outline-Checklist,* N.Y.U. 21ST INST. ON FED. TAX 1065 (1963); *Sale of a Corporate Business: A Panel Discussion, id.* at 1143.

frequently wishes to purchase assets; while the seller, aware of the clean transaction and definite capital gain treatment arising from the sale of stock, holds out for the sale of stock. Again, tax and other considerations will usually mold the transaction. A logical and much used compromise between buyer and seller, however, is for the buyer to purchase stock based upon written representations and warranties by the selling stockholders regarding the corporation's obligations and liabilities. These representations and warranties should survive the closing of the purchase and should be coupled with full indemnification by the seller in favor of the buyer. This indemnification is given strength and certainty when coupled with a retention of a part of the purchase price or the placement of part of the consideration into escrow pending a determination of all liabilities under the indemnification.

The purchaser of a business ordinarily wishes to own the entire business, without minority interest holders. The structuring of an acquisition frequently depends upon the temperament and attitudes of the selling parties. If the purchaser is buying stock, it must acquire one hundred percent of the stock or live with minority interest holders. If, on the other hand, there are some stockholders of the selling corporation who object to the transaction, the buyer may decide to purchase assets from the selling corporation. The acquisition of assets requires proper corporate action. This includes meetings of directors and stockholders of the selling corporation with the attendant notices, meetings and minutes.[2] Furthermore, when the sale of assets takes place at the corporate level, the transaction is called a "de facto merger," and the business corporation laws of a majority of states grant stockholders the right of dissent and appraisal whereby the stockholder who objects to the sale may, through proper procedures, demand and receive a higher cash price for his

[2] DEL. GEN. CORP. LAW § 271 (1967); OKLA. STAT. tit. 18, § 1.64 (1961); 13 W. FLETCHER, CYCLOPEDIA OF CORPORATIONS § 5797 (rev. ed. 1961).

stock.[3] Thus, the sale of assets at the corporate level may eliminate minority interests but, because of the possible right of dissent and appraisal, the purchase price may be higher.

An acquisition by means of a merger or consolidation consummated pursuant to the laws of the state of incorporation of the constituent corporations results in many of the same advantages and disadvantages as discussed above. In a statutory merger all the assets are automatically acquired by the surviving corporation, but the surviving corporation also assumes all of the merging corporation's obligations by operation of law.[4] The stockholders of the constituent corporations must approve the merger and they always enjoy dissent and appraisal rights in a merger.[5] Stockholders of the acquiring corporation usually are not required to meet to approve an acquisition of assets. Consequently, unless the transaction is worth the expense of proxy solicitations, stockholder meetings, payments to dissenters and the legal, accounting and printing costs of such a transaction, statutory mergers are avoided.

[3] OKLA. STAT. tit. 18, § 1.157(b) (1961); 13 W. FLETCHER, *supra* note 2, at § 5895. The statutes of many states are silent as to the rights of dissent and appraisal in the sale of all assets resulting in litigation. *See, e.g.*, Hariton v. Avco Electronics Inc., 40 Del. Ch. 326, 182 A.2d 22 (Ch. 1962), *aff'd*, 41 Del. Ch. 74, 188 A.2d 123 (Sup. Ct. 1963).

[4] DEL. GEN. CORP. LAW § 259(b) (1967); OKLA. STAT. tit. 18, § 1.167(4) (1961); 15 W. FLETCHER, *supra* note 2, § 7103.

[5] DEL. GEN. CORP. LAW § 262 (1967); OKLA. STAT. tit. 18, § 1.157(d) (1961); 15 W. FLETCHER, *supra* note 2, §§ 7157-67. DEL. GEN. CORP. LAW § 262(k) (1967) eliminates rights of dissent and appraisal to classes of stock registered on a national securities exchange, held by more than 2,000 stockholders or in a merger not requiring stockholder approval as set out in DEL. GEN. CORP. LAW § 251 (f) (1967).

SOME TAX CONSIDERATIONS OF ACQUIRING STOCK VS. ASSETS[6]

In a corporate acquisition, other than a "tax free" reorganization, the selling corporation and its stockholders wish to receive capital gains treatment for income tax purposes. They also want to avoid the so-called "double tax"—to the stockholders on the sale of the stock, and to the corporation if it sells its assets for a price in excess of their tax basis, or if it must pay federal income tax on the depreciation[7] or on the investment credit[8] taken on its property in excess of the permitted amounts.

Consequently, stockholders usually prefer to sell their stock. The sale of stock assures the selling stockholders of capital gains treatment for federal and state income tax purposes. Of course, with the sale of stock the corporation continues its existence without any change in the basis of its assets. There is no tax at the corporate level since the corporation has not made a sale; thus, there is no problem of depreciation recapture or forfeiture of the investment credit.

The rub to the buyer is that he may have paid more for the stock than the book value of the corporation's assets as computed for tax purposes. For example, the selling corporation's assets may be depreciated for tax purposes far below their actual value upon which the transaction is calculated. The sales price for the stock may be $100,000 while the corporation's assets may have a tax basis of $50,000. Since the corporation continues without a change, the basis of its assets continues and the buyer will not be able to depreciate the assets on the basis calculated on the new pur-

[6] Bartolini, *Taxable Sale and Purchase of a Corporate Business,* 21 BUS. L. 809 (1966); Freling, *Tax Consequences of Non-tax Motivated Aspects and Factors in the Sale of a Corporate Business,* N.Y.U. 21ST INST. ON FED. TAX 1107 (1963).

[7] INT. REV. CODE of 1954, §§ 1245, 1250.

[8] *Id.* § 47.

chase price—$100,000 in our example—but must continue to depreciate on the existing tax basis—$50,000 in our example.

It is often to receive a "stepped up" basis that a buyer will demand to purchase assets rather than stock. This point becomes particularly critical in businesses which have a high ratio of depreciable or depletable assets such as real estate or natural resources business. The desire for a "stepped up" basis is not so important in a merchandising or service business whose assets chiefly consist of non-depreciable inventories and receivables and good will.

Apparently aware of this constant conflict between sellers who wish to sell stock and buyers who wish to purchase assets, Congress has included in the Internal Revenue Code two sections which provide partial relief to this conflict. Section 337 allows a corporation to sell its assets for a price in excess of their tax basis and avoid double taxation at both the corporate and stockholder levels. Section 334(b)(2) allows a purchaser to receive a "stepped up" basis in assets of a corporation even though the purchaser acquired stock and not assets.

In the wake of the famous *Commissioner v. Court Holding Co.*[9] case, Congress adopted Section 337 of the Internal Revenue Code. This section provides that if a corporation adopts a plan of complete liquidation and then distributes all of its assets, except those needed to pay debts, within twelve months after the adoption of the plan, the corporation will not recognize gain or loss from the sale of its assets during this period.[10] When the technical rules and strict application of Section 337 are adhered to by the liquidating corporation,

[9] 324 U. S. 331 (1945).

[10] B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND STOCKHOLDERS § 9.63 (2d ed. 1966); Boland, *A Review of Developments Under Section 337 of the Internal Revenue Code of* 1954, 42 TAXES 676 (1964); *Dohan, Recent Developments Under Section 337: Effect of Other Code Sections,* N.Y.U. 25TH INST. ON FED. TAX 297 (1967); Note, *Tax-Free Sales in Liquidation Under Section* 337, 76 HARV. L. REV. 780 (1963).

Section 337 provides the corporation with important benefits which greatly reduce the sting of selling appreciated assets.[11]

However, Section 337 does not eliminate all the tax problems of selling assets. Most state income tax laws do not have provisions similar to Section 337, and as a result there is usually a state income tax at both the corporate level and at the stockholder level. Section 337 does not prevent the recapture of depreciation under Sections 1245 and 1250 and of investment credit if applicable to the sale. Section 337 necessitates a complete liquidation of a corporation, and this may not be the desire of the stockholders who may wish only to sell a portion of its assets.

If the wishes of the seller prevail and the buyer acquires stock rather than assets, the buyer still may enjoy the benefits of a "stepped up" basis in the assets of the corporation whose stock was purchased by the application of Section 334(b) (2).

As a general principle, Section 332 provides that when a subsidiary corporation is liquidated into its eighty percent or more parent there is no recognized tax consequence for federal income tax purposes. As a usual corollary to the non-recognition provisions of Section 332, there is no adjustment in the basis of assets. Section 334(b) (1) specifically provides that property received by the parent corporation adopts the basis the property had in the hands of the subsidiary corporation. In businessmen's language, a corporation cannot generally get a "stepped up" basis when it purchases stock in another corporation, thus causing the corporation whose stock was purchased to become a subsidiary and subsequently liquidates the subsidiary to receive the assets which were in fact the object of the purchase. This general rule obviously discouraged the purchase of stock until Congress adopted an exception to the general rule in the form of Section 334(b) (2).

[11] Rev. Rul. 65-30, 1965-1 CUM.BULL. 112 states that § 337 is not elective but is mandatory to any situation fitting the requirements of § 337(a).

Section 334(b)(2), which is a statutory enactment of the court made rules of the celebrated *Kimbell-Diamond Milling Co. v. Commissioner*[12] case, provides that a corporation's basis in assets acquired by liquidation of its subsidiary in a Section 332 transaction will be the cost of the stock in that subsidiary provided that at least eighty percent of the stock was purchased during a period of not more than twelve months and that the plan of liquidation of the subsidiary was adopted within two years from the date of the last purchase of stock.

While the regulations and requirements are rather technical and must be carefully complied with, Section 334(b)(2) means that the businessman can buy stock and get the same "stepped up" basis advantage as if he had purchased assets.[13]

Because of the necessity of allocating the purchase price among the assets being acquired, there should be a specific allocation set forth in the contract for purchase of the stock based on the fair market value of the specific assets as adjusted for liens and encumbrances on the specific assets. One difficulty is the amount of consideration which is to be placed on the good will of the acquired business.

But the treatment of good will and other intangible assets is always a problem in an acquisition of a going business and thus should be considered as part of what is being acquired.

Good Will[14]

One of the main motivations for acquiring a going business instead of starting a new concern in the same business

[12] 14 T.C. 74, *aff'd mem.*, 187 F.2d 718 (5th Cir. 1950), *cert. denied*, 342 U.S. 827 (1951).

[13] B. Bittker & J. Eustice, *supra* note 10, at § 9.44; O'Malley, *The Pitfalls of Section 334(b)(2) Liquidations and How to Avoid Them*, 24 J. Tax 138 (1966).

[14] Harnack, *The Commissioner Is Looking for Good Will*, 40 Taxes 331 (1962); Scheifly, *The Personal Service Business*, N.Y.U. 25th Inst. on Fed. Tax 265, 277 (1967); *Tax Planning: Its Relationship to Corporate Legal and Financial Problems*, N.Y.U. 25th Inst. on Fed. Tax 817, 910 (1967) (panel discussion).

is the likelihood that customers who have done business will continue to do business despite a change in ownership. It takes time to establish an organization and customers and to develop management which can make profits. For that reason the purchase price for a going business is usually more than the fair market value of the net tangible assets of the acquired firm. In accountants' language, the purchase price often exceeds the book value. This excess purchase price over net book value is the price the purchaser is willing to pay for the intangible asset businessmen call "good will."

The Internal Revenue Code does not define good will and the courts, while there has been a considerable amount of litigation, have not been particularly successful at defining good will. Some courts have seen good will as "the expectancy of continued patronage, for whatever reason"[15] or "the probability that old customers will resort to the old place."[16] Other courts have broadly seen good will as a characteristic of a "business sufficiently permanent in character to include not only its customers, but the incidents of locality and a distinctive name."[17] In attempting to apply a formula to good will some courts have viewed good will as an intangible consisting of the excess earning power of a going business which may result from good reputation, customers' lists, brand names and secret processes.[18]

To return to an earlier example, a purchaser may pay $100,000 for a going business whose tangible assets have a tax basis of $50,000 and a fair market value of $75,000. The remaining $25,000, the difference between the purchase price and the fair market value of the tangible assets, is the consideration for good will.

Regardless of whether the transaction is a purchase of assets or a purchase of stock in a Section 334(b)(2) trans-

[15] Boe v. Commissioner, 307 F.2d 339, 343 (9th Cir. 1962).
[16] Merle P. Brooks, 36 T.C. 1128 (1961).
[17] Schulz Baking Co., 3 B.T.A. 470, 473 (1926).
[18] George J. Staab, 20 T.C. 834 (1953).

action, the problem of how to handle good will is always a major point in the negotiations. In a stock purchase not accompanied by a Section 334(b)(2) liquidation or in a statutory merger, there will be no step up in basis - so good will does not present a serious tax problem as in an asset purchase. As a business consideration good will is very difficult to value. A seller always remembers the years of hard work, disappointments and mistakes which are a part of building a business and he wants to be rewarded for them. A buyer knows that he can usually purchase the physical assets required and begin a competing business across the street and thus pay nothing for good will.

Good will also presents a major tax problem. Federal Income Tax Regulation Section 1.167(a)-3 states: "No deduction for depreciation is allowable with respect to good will." On the other hand, generally accepted accounting principles require purchased good will to be amortized against income over an arbitrary period such as ten years.[19] Thus the buyer of a going business ordinarily does not wish to put much value on good will. If the money is to be paid for good will, the buyer usually wishes it to be paid in the form of a deductible expense such as an advisory or consulting contract to the individual stockholder. But good will is a capital asset and its sale will result in the more favorable capital gains treatment to the seller.[20]

Against the background of the dichotomy between buyer's and seller's wishes, which can usually be settled by negotiation, there is the tax requirement that the cost of a going business be allocated among the specific assets which have been acquired—both those tangible and intangible and those depreciable and non-depreciable. Where all of the assets of a going business have been acquired the purchaser must

[19] AM. INST. OF CPAS, ACC'T'G RESEARCH AND TERMINOLOGY BULL. No. 43, Ch. 5 (Final ed. 1961).
[20] INT. REV. CODE of 1954, § 1221; 5 CCH 1967 STAND. FED. TAX REP. ¶ 4717.096.

make an allocation based on the fair market value of each asset.[21] In a Section 334(b)(2) transaction the *Regulations* specifically require: "the amount of the adjusted basis of the stock . . . shall be allocated as basis among the various assets received (except cash and its equivalent) both tangible and intangible (whether or not depreciable or amortizable). Ordinarily, such allocation shall be made in proportion to the net fair market values of such assets on the date received . . . ."[22]

The buyer, of course, wishes to allocate most of the purchase price to depreciable assets and, thus, very little of the cost is allocated to non-depreciable assets—specifically to good will. However, a complete omission of an allocation for good will or an obvious and blatantly excessive evaluation of depreciable assets usually opens the door for the Internal Revenue Service to redetermine the allocation of the purchase price. Since the allocation will ordinarily be reviewed in connection with the depreciation of the acquired assets, the transaction will have been closed long before. The Internal Revenue Service, despite its official position,[23] will ordinarily determine the value of good will by applying a capitalization formula set out in 1920 in A.R.M. 34, as modified by A.R.M. 68.[24] Under such a formula, a certain capitalization of average earnings will be allocated to a reasonable return on tangible assets and the remainder will be attributed to intangibles. Another method used by the Internal Revenue Service is to determine the fair market value of all of the assets acquired and to subtract that amount from the total purchase consideration to arrive at a resulting figure for good will. Obviously, the taxpayer could be severely damaged from such an allocation.

[21] INT. REV. CODE of 1954, § 1011; Treas. Reg. §61-1 (1957); 5 CCH 1967 STAND. FED. TAX REP. ¶ 4512.
[22] Treas. Reg. § 1.334-1 (c) (viii) (1955).
[23] Rev. Rul. 65-192, 1965-2 CUM. BULL. 259.
[24] Harnack, *supra* note 14, *analyzing* North American Service Co., 33 T.C. 677 (1960).

A good way to solve the good will problem is to have the parties set forth, as an exhibit to the purchase contract, an allocation of the values of all assets—tangible and intangible—based on the values used by the parties. Of course, the specification of values will not impress the examining agent if values have been assigned for the obvious benefit of one of the parties.[25] However, a realistic and objective allocation of values should reduce the risk of future adjustment upon examination. If the allocation problem is critical and if a great deal of the consideration is for good will, an appraisal by independent and respected authorities is very helpful.

The purchaser must be prepared to defend its allocation of purchase price among the assets acquired. As one reviewer has stated:

> If past litigation is any measure, the Tax Court can usually recognize a patently invalid allocation. The court appears to have more difficulty in determining their existence . . . . Additionally, when no allocation has been made, the purchaser may be forced to assume an inconsistent position. The initial contention that no allocation to intangible is required because no good will was acquired, that is, that purchaser's original allocation is proper is irreconcilable with the secondary defense, that being, that the Commissioner's determination of good will is excessive.[26]

WHAT IS THE CONSIDERATION TO BE PAID? CASH, NOTES OR STOCK?

While the asset to be acquired is important, the success of most corporate acquisitions depends upon the consideration to be paid. The parties are, of course, interested in the amount of consideration to be paid, but they are also vitally interested in the kind of consideration, since it is principally the kind of consideration which determines such key ques-

[25] Copperhead Coal Co., 17 CCH Tax Ct. Mem. 30 (1958), *aff'd*, 272 F.2d 45 (6th Cir. 1959); Sidney LeVine, 24 T.C. 147 (1955).

[26] Harnack, *supra* note 14, at 338.

tions as whether the transaction is taxable or "non-taxable," whether the buyer receives a "stepped up" basis, whether the stock used to acquire the business must be registered with securities regulation agencies, and whether the acquisition will be treated as a "pooling of interests" or as a "purchase" for accounting purposes.

Cash and Notes

If the buyer pays the seller cash, either at the closing or on a deferred payment basis with the use of promissory notes, debentures or other forms of indebtedness, the transaction will be taxable and the seller will incur a tax based on the assets sold. If the stock is sold, the seller's profit will be taxed at the capital gains rate[27] or the loss will be treated as a capital loss.[28] The purchaser of stock will acquire a basis in the stock equal to the cash or deferred payment given for the stock, which basis will continue unless transferred to the assets underlying the stock in a Section 334(b)(2) transaction.[29]

In a sale of assets, the corporation, in the absence of a Section 337 application and subject to recapture of depreciation and recapture of investment credit rules,[30] will receive capital gain or loss treatment on all of its assets which are classified as capital assets.[31] The purchaser applies the purchase price to the acquired assets to establish the basis in such assets.

Installment Sales and Imputed Interest

If the seller of stock or of assets, by reason of the sale, realizes a large profit, it may be advantageous to spread

[27] INT. REV. CODE of 1954, § 1201.
[28] *Id.* § 1212.
[29] *Id.* § 1012.
[30] *Id.* §§ 1245, 1250, 47.
[31] This would ordinarily be land, buildings, equipment and machinery, good will and other assets not held primarily for resale to customers. The sale of inventory, accounts receivable, supplies already paid for, and prepaid expenses would be taxed at ordinary income rates. INT. REV. CODE of 1954, § 1221; Rev. Rul. 55-79, 1955-1 CUM. BULL. 370.

the payment of the resulting capital gains tax over several years by means of the installment sale provisions of Section 453. In this context, Section 453 provides that income from a sale of property in which less than thirty percent of the selling price is received by the seller in year of sale may be taxed proportionally in the year in which the deferred payments are actually received. Because of graduated income tax rates it is often advantageous to receive less than thirty percent of the purchase price in the year of sale with an installment note for the balance.

Since the buyer usually prefers to finance the acquisition by a note payable to the seller, this method is frequently used in the acquisition of stock. With the interest factor on the purchase note, the seller has, in essence, changed his investment from stock to a debt security, a change which he must consider desirable or he would not sell his stock.

It is difficult to have the tax advantages of an installment sale in a corporate sale of substantially all of its assets at the corporate level. A corporation which, pursuant to Section 337, adopts a plan of complete liquidation and sells all of its assets in exchange for an installment obligation, will not incur any tax other than in a normal Section 337 transaction.[32] However, upon distribution of the installment obligation to the stockholders as a liquidating distribution, the stockholders will realize gain or loss to the extent that the fair market value of the installment obligation and other property distributed exceeds the stockholder's basis in the stock.[33] Since the individual stockholder may not enjoy the installment sale provisions, he must pay tax in the year he receives the installment obligation even though he may not receive cash payment for several years.

Since interest paid on notes and other forms of indebtedness is taxed at ordinary income tax rates,[34] the sale of a

[32] INT. REV. CODE of 1954, § 453(d) (4) (B).
[33] *Id.* §§ 331, 1001; 3 CCH 1967 STAND. FED. TAX REP. ¶ 2876.016.
[34] INT. REV. CODE of 1954, § 61.

corporate business frequently gave rise to an addition to the principal of the purchase price of a sum which was in fact paid as interest on the principal. The addition was thus taxed at lower capital gains rates and resulted in a corresponding reduction or elimination of the interest factor. For example, if stock was sold for $100,000 payable by the buyer's promissory note in five equal annual installments of principal with interest on the unpaid balances of principal at six percent, then the seller would receive $17,800 of interest which if taxed at fifty percent would result in a net receipt of $8,900. If, on the other hand, the note was for a principal amount of $117,800, the seller, after reduction of twenty-five percent on the $17,800 for maximum long term capital gains tax, would receive $12,350 net. Except for the fact the seller would not receive a deduction for interest paid, for which adjustments could be made, the cash involved would be the same to both buyer and seller.

Aware of this frequent transfer of ordinary income into capital gain income, Congress, in 1964, adopted Internal Revenue Code Section 483. In simplest terms, Section 483 imputes interest to a payment representing part of the purchase price in a sale of property if interest on the deferred payment is unstated or is below the allowable four percent per annum simple interest prescribed in the regulation.[35] Care must now be taken to include an interest factor in deferred payment obligations.

CONSULTING CONTRACTS AND COVENANTS NOT TO COMPETE

The consideration paid for the purchase of stock or assets must be capitalized and, as we have seen above, the amount of consideration allocated to good will may not be depreciated or amortized or otherwise deducted against other income. Because of the desire to receive a deduction for a portion of

[35] Treas. Reg. § 1.438-1(d) (2) (1966); Cohen, *Imputed Interest in the Sale of a Business*, N.Y.U. 23RD INST. ON FED. TAX 487 (1965).

the purchase price, purchasers of going businesses constantly look for deductible methods of paying part of the purchase price and frequently attempt to use consulting or advisory contracts and covenants not to compete in situations where the seller's owners are also its operating executives and employees.

It is normal for a buyer to want the advice and experience of the seller's key executives to help manage the purchased business. Thus, it is normal for these key executives to execute an advisory or a consulting contract with the buyer. The payments under such a contract are clearly deductible as ordinary and necessary business expenses[36] if the payments are reasonable in amount, actually paid and based on services actually performed.[37] The problem, of course, is that if the payment is in fact being made for the purchase of property it is not for services actually performed, and such payments must be capitalized.

Tax counsel should consider the following factors related to an advisory contract resulting for a sale of a going business: *First,* is the advisor actually going to advise? If the advisor is not required to spend time or does not have an office near the advisee the possibility of deductibility is reduced. *Second,* the advisory contract should be in an instrument separate from the sales contract.[38] *Third,* if the advisory compensation is to continue even after death of the advisor the payments certainly must be capitalized.[39] The advisory contract, to stand up, must terminate upon the death of the advisor so it may be wise to increase the amount of compensation to pay premiums on insurance on the advisor's life. *Fourth,* if there are multiple advisory contracts under

[36] INT. REV. CODE of 1954, § 162.
[37] Treas. Reg. § 1.162-7 (1956); 2 CCH 1967 STAND. FED. TAX REP. ¶ 1370.013.
[38] Green & Green, 11 B.T.A. 643 (1928).
[39] Frederich Pfeifer Corp., 14 T.C. 569 (1950); Green & Green, 11 B.T.A. 643 (1928).

which the compensation is proportionate to stock ownership or if there are advisory contracts for people who do not have the ability to advise—people not actively engaged in the management of the business such as minors or wives—the amounts paid are almost certain to be capitalized. A careful log of the advisory services and time should be kept to substantiate the advisory contract.

In many corporate acquisitions, the success of the acquired business has been the result of incumbent management's ability and efforts; and if this same management set up a similar business across the street, the purchased business would be severely damaged. Therefore, as a normal part of an acquisition, the key executives and employees are often requested to execute a covenant not to compete with the purchased business for a specified period of time. Since these key employees are often also the selling stockholders, there is a possibility of putting a portion of the purchase price under such a covenant.

If the covenant not to compete is a part of the sales contract and is necessary to protect the good will of the purchased business, then, clearly, the payments made for the covenant not to compete are not deductible and must be capitalized.[40]

On the other hand, the cases seem to indicate that amounts paid for a covenant not to compete may be an amortizable deduction when paid if: *first,* there is a separate and specific amount allocated to the covenant;[41] *second,* the covenantor has the ability to compete and gave up an opportunity to go elsewhere, and the purchaser is unwilling to purchase without a

[40] Aaron Michaels, 12 T.C. 17 (1949); Scheifley, *The Personal Service Corporation,* N.Y.U. 25TH INST. ON FED. TAX 265, 229 (1967); 2 CCH 1967 STAND. TAX REP. ¶ 1717.026.

[41] Ullman v. Commissioner, 264 F.2d 305 (2d Cir. 1959); Commissioner v. Gazette Telegraph, 209 F.2d 926 (10th Cir. 1954). *But see,* Teledo Blade Co., 11 T.C. 1079 (1948), *aff'd mem.,* 180 F.2d 357 (6th Cir. 1950), *cert. denied,* 340 U.S. 811 (1950).

covenant; and *third,* where the covenant is given for the personal ability and experience of the covenantor.[42]

Of course, if the payments under an advisory contract or under a covenant not to compete are deductible for the payor, they are also includible as ordinary income by the recipient thereof. If such payments arise out of negotiations relating to a sale of a corporate business, an adjustment for the tax differential between the capital gains tax on the purchase price and the ordinary income tax on the deductible payments may be in order.

ISSUANCE OF STOCK IN PAYMENT OF CONSIDERATION

A corporation may, under business corporation laws,[43] issue shares of its stock in connection with its acquisition of the stock or assets of another corporation or pursuant to a statutory merger. The acquiring corporation generally likes to make payment in its stock because it does not then need to raise the cash purchase price or use its credit in connection with a debt obligation.

Since the seller receives the buyer's stock, the seller is then forced to analyze and accept both the future profitability of the buyer and the future price of its stock. It is fundamental that the seller really only exchanges one form of intangible property for another; thus its interest continues and the seller or its stockholders remain at market risk. Practically, therefore, only corporations whose stock is publicly traded or whose stock is soon to be distributed to a public market are able to make acquisitions with stock.

Such acquisitions for stock might not be so acceptable except that the form of consideration—the issuance of stock —is a primary requirement for causing the entire transaction to come within the "tax free reorganization" provisions

[42] 4 CCH 1967 STAND. TAX REP. ¶ 4430.33.

[43] DEL. GEN. CORP. LAW § 152 (1967); OKLA. STAT. tit. 18, § 1.76 (1961); 11 W. FLETCHER, CYCLOPEDIA OF CORPORATIONS § 5187 (rev. ed. 1958).

of the Internal Revenue Code.[44] By accepting stock and otherwise carefully complying with the requirements for a "tax free reorganization," the successful businessman, who has caused a business to prosper and thus would have a large profit with the related capital gains tax if the business were sold for cash or indebtedness, may exchange his stock for that of a corporation whose shares are traded on a national securities exchange and postpone the payment of any federal income tax until a voluntary cash sale of the stock by the recipient.

As an estate planning procedure, the tax free exchange of stock in a privately held, often family owned, corporation for the stock of a publicly held corporation greatly reduces the thorny problems of valuation of the closely held corporation for estate tax problems, the lack of liquidity with which to pay estate taxes and the necessity for competent successive management.[45] Since an estate receives a "step up" in basis to the fair market value of an asset on date of death,[46] it is possible for a businessman to have millions of dollars of appreciation in the stock of his corporation and never pay income taxes on this appreciation, even though a portion of the stock is sold for cash upon his death.

For the above and numerous other reasons, the tax free corporate reorganization has become a very popular and useful method of acquisition.[47] A complete explanation of the many facets of tax free reorganizations has been the subject of numerous papers and is under constant review and comment. What follows must concern only the fundamentals.

[44] INT. REV. CODE of 1954, §§ 354, 368.

[45] Sneed & Will, *Family Corporation Uses in Estate Planning,* 20 OKLA. L. REV. 243 (1967).

[46] INT. REV. CODE of 1954, § 1014.

[47] Darrell, *The Use of Reorganization Techniques in Corporate Acquisitions,* 70 HARV. L. REV. 1183 (1957).

TAX FREE REORGANIZATIONS[48]

Section 354 of the Internal Revenue Code provides that "no gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of a plan of reorganization, exchanged solely for stock or securities in such corporations . . . ." Section 368(a)(1) defines the three basic types of "reorganizations" used in corporate acquisitions as:

1. A statutory merger or consolidation ("Type A");

2. The acquisition by one corporation, in exchange solely for all or a part of its voting stock . . . of another corporation if, immediately after the acquisition, the acquiring corporation has control of such other corporation ("Type B"); and

3. The acquisition by one corporation, in exchange solely for all or a part of its voting stock . . . of substantially all of the properties of another corporation ("Type C").

Types A and C are used to acquire assets while Type B is used to acquire stock and thereby acquire a subsidiary corporation.

Assuming that a transaction qualifies as a reorganization under Section 368, then three important tax consequences arise:

First, the individual stockholders will not recognize gain or loss on an exchange of securities arising out of a reorganization.[49]

Second, the corporations which are parties to the plan of reorganization will not recognize gain or loss if they exchange property for stock or securities in a reorganization.[50]

Third, the basis of the stock owned by the stockholders shall be transferred to the stock or securities in the acquiring

[48] *See generally,* B. BITTKER & J. EUSTICE, *supra* note 10, at Ch. 12.

[49] INT. REV. CODE of 1954, § 354.

[50] *Id.* § 361.

corporation received in exchange by these stockholders,[51] and the basis of property owned by corporations which are parties to the reorganization shall be transferred to the acquiring corporation.[52]

The "reorganization" sections of the federal income tax law are considered among the most complex provisions of the Internal Revenue Code, and compliance with the provisions of Section 368 must be handled with great caution and care. Such care includes the receipt of a ruling from the Reorganization Branch of the Tax Ruling Division of the Internal Revenue Service's National Office in planned reorganizations which have any unusual aspects or complexities.[53]

A merger consummated pursuant to statutory provisions of the states of incorporation of the constituent corporations (Type A) is the most flexible type of reorganization since the Code does not impose restrictions on the type of consideration to be used in the merger. Unlike Types B and C reorganizations, non-voting stock, either common or preferred, and securities, such as long term debentures, may be used in a Type A reorganization. Money and other property may be distributed pursuant to a merger statute and, while classified as "boot,"[54] will not disqualify the entire transaction as in the case of a Type B or some Type C reorganizations.[55]

A Type B reorganization works beautifully when a public corporation acquires all of the stock of a closely held corporation in exchange for voting stock. The practical difficulty is that it is a stock acquisition device and thus must be agreed to by all of the stockholders of the acquired corporation. Type

[51] *Id.* § 358.
[52] *Id.* § 362.
[53] Freling, *What is New in Subchapter C: The Services Current Ruling Policy,* N.Y.U. 23RD INST. ON FED. TAX 421 (1955).
[54] INT. REV. CODE of 1954, § 356.
[55] B. BITTKER & J. EUSTICE, *supra* note 10, at § 12.14; 3 CCH 1967 STAND. FED. TAX REP. ¶ 2551.27.

B reorganizations are the least flexible to achieve in that any consideration other than voting stock—such as cash for fractional shares, expenses, assumption of stockholders liabilities, and sometimes even employment contracts and agreements to register stock—may completely destroy the tax free aspects of the reorganization.[56]

A Type C reorganization is frequently used by public corporations to acquire substantially all of the assets of smaller public corporations because of the advantages of acquiring assets without the necessity of a stockholders meeting. A Type C reorganization is frequently called a "de facto merger" or a "practical merger."[57]

In a Type C reorganization the acquiring corporation must acquire substantially all of the properties of the other corporation. While the "substantially all of the properties" rule has been well litigated, the percentage of property retained by the acquired corporation, the nature of the retained assets and the purpose of the retention control the "substantially all" test. If cash or accounts receivable equal to less than ten percent of the total properties are retained to pay liabilities not assumed by the acquiring corporation, the requirement will ordinarily be met. Other intended retentions of assets should be carefully reviewed.[58] Difficulty, if any, usually comes with the "solely for voting stock" requirement. In a Type C reorganization, this requirement will be met

[56] B. BITTKER & J. EUSTICE, *supra* note 10, at § 12.13; Brew, *Uses and Effects of Different Kinds of Stock of Organization, Reorganization and Liquidation,* N.Y.U. 24TH INST. ON FED. TAX 1023, 1036 (1966); Carruthers, *How to Treat Expenses of Organization, Reorganization and Liquidation,* N.Y.U. 24TH INST. ON FED. TAX 1055, 1076 (1966); Rosenweig, *The "Bout" Peril—What is "Solely" Under Section* 368(a)?, N.Y.U. 24TH INST. ON FED. TAX 995 (1966).

[57] B. BITTKER & J. EUSTICE, *supra* note 10, at § 12.14; Goldman, *The C Reorganization,* 19 TAX L. REV. 31 (1963).

[58] Rev. Proc. 66-34 1966 INT. REV. BULL. No. 34 at 22; Rev. Rul. 57-518, 1957-2 CUM. BULL. 253; Goldman, *supra* note 57, at 42.

even though up to twenty percent of value of the acquired assets are purchased for something other than voting stock —even cash or other property[59]—although this cash or other property will be taxable as boot,[60] and even though the acquiring corporation assumes liabilities or takes properties subject to liabilities and thereby eliminates the acquired corporation's responsibilities for these obligations.[61]

The "solely voting stock" requirement of Types B and C reorganization is deceptively simple when in fact its pitfalls are numerous and dangerous.[62] On the other hand, the "voting stock" requirement, which essentially means any class of stock which permits the holder "the right to significant participation in management of the affairs of the corporation,"[63] permits the imaginative lawyer to create various types of stock suited to the financing and circumstances of an acquisition.[64]

Two areas of imaginative financial arrangements deserve special comment: namely, the use of voting convertible preferred stock and the use of installment and contingent payouts of stock in corporate acquisitions.

Convertible preferred stock, designed with full voting rights to meet the requirements for Type B and C reorganizations, has become an ideal—almost indispensable—acquisition tool.[65] The corporation being acquired or its stockholder receives the dividend paying preferred stock whose value will remain relatively stable and is without the same market risk that the common would have. The option to convert the preferred into common gives the security its

[59] INT. REV. CODE of 1954, § 368(a)(2)(B).
[60] *Id.* § 356; B. BITTKER & J. EUSTICE, *supra* note 10, at § 12.14(2); Goldman, *supra* note 57, at 63.
[61] INT. REV. CODE of 1954, § 368(a)(1)(C).
[62] Rosenzweig, *supra* note 56.
[63] Rev. Rul. 63-234, 1963-2 CUM. BULL. 148.
[64] Brew, *supra* note 58, at 1036.
[65] Wall Street Journal, Dec. 27, 1966, at 1, col. 6.

growth potential and glamour appeal. For the issuer-acquirer, the convertible preferred reduces or at least postpones the dilution to the common stock which occurs upon the issuance of additional common shares. Of course, good financial analysis requires financial information to be computed as if the shares had been converted, and this may soon be required by the SEC.

In acquisition negotiations, the parties will frequently differ as to the future profitability of a corporation or may be unable to ascertain certain contingencies including contingent liabilities or pending profit applications. For this reason, the parties may wish the stock to be issued in an acquisitive reorganization, to be issued in the future and to have this issuance contingent upon future events such as future earnings of a corporation. The stock may also be issued in installments or delayed issuances. The Internal Revenue Service, however, has challenged agreements for the contingent or delayed issuances of stock on the grounds that the contractual obligation to issue stock was something other than voting stock and that the "solely voting stock" requirement has not been met.[66]

The controversy over contingent and installment issuances of stock in Types A, B and C reorganizations ended with the issuance of Revenue Procedure 66-34,[67] in which the Service states that it will issue favorable rulings to the effect that in Types A, B and C reorganizations it is not necessary for all of the stock of the acquiring corporation to be issued at the closing of the transaction if five requirements regarding the delayed issuances are met. *First,* all of the stock must be issued within five years from the date the assets are transferred in a Type A or C or the date of the stock exchange in the case of a Type B reorganization. *Second,* there must

[66] B. BITTKER & J. EUSTICE, *supra* note 10, at 579; Freling, *supra* note 6, at 1130; Rosenzweig, *supra* note 56, at 1004.
[67] 1966 INT. REV. BULL. No. 34, at 22.

be a valid business purpose for not issuing all of the stock, such as difficulty of determining the value of the corporation being acquired. *Third,* the maximum number of shares to be issued must be stated. *Fourth,* the agreement regarding future stock must be non-assignable, or if assignable, must not be evidenced by negotiable certificates of any kind and must not be readily marketable. *Fifth,* this right shall apply only to additional stock of the acquiring corporation. These guidelines were amplified by Revenue Procedure 67-13[68] which makes the additional requirement that at least fifty percent of the maximum number of shares of each class of stock must be issued initially.

A serious drawback to the use of delayed issuance of stock is the application of the imputed interest rules of Section 483 to issuance of stock to be made more than one year in the future.[69] Two possible solutions to this problem are limiting the delayed issuance of stock to one year or placing the contingent stock in escrow, since escrow stock is not subject to Section 483 application.[70]

While the Type A merger is the most flexible type of reorganization, the Type B exchange of stock is the most restrictive and the Type C acquisition of assets stands in the middle. Thus, the choice of acquisitive reorganization may well turn on the securities regulations attendant to each type rather than on tax considerations.

Securities Regulations in Acquisitions

If an acquiring corporation pays cash for the stock of another corporation or pays that corporation cash for its assets, it is not subject to any securities regulations. But, if

[68] 1967 Int. Rev. Bull. No. 13, at 22.

[69] Treas. Reg. § 1.483-2(a) (2) (1966) applies imputed interest to a tax free reorganization but this application does not prevent qualification under the reorganization sections.

[70] Treas. Reg. § 1.483-1(b) (ex. 8) (1966); Freling, *supra* note 6, at 1136.

the acquiring corporation pays for its purchases with anything other than cash or tangible property, it must review the federal securities laws and the state "blue sky" regulations to see if the transaction is exempt from the securities regulation requirements or whether compliance—usually registration of securities—is required.

In most taxable acquisitions the acquiring corporation desires to issue its debt securities—debentures, notes and other obligations—and, of course, in "tax free" reorganizations the acquiring corporation usually issues some type of stock or equity security. These are securities and registration is required in compliance with the Securities Act of 1933[71] and the similar state securities laws. However, two principal exemptions from the securities laws allow securities to be issued in corporate acquisitions without registration.

The Securities Act of 1933 requires registration of securities unless either the security or the transaction is exempt from registration. Section 4(1) specifically exempts "transactions by an issuer not involving any public offering." This "private placement" exemption has received much comment and review.[72] In businessmen's language, it says that securities do not need to be registered under the federal securities laws if the offerees to whom securities are to be issued: *first,* are adequately informed about the issuing corporation; *second,* at the time the securities are received the takers thereof have the intention to acquire the stock for investment and not with a view of distributing the securities to other parties; and *third,* are limited in number.

The first requirement of adequate information is easily

[71] 15. U.S.C. § 77e (1964).

[72] 1 L. Loss, SECURITIES, REGULATION 653 (2d ed. 1961); SEC Securities Act Release No. 4552 (Nov. 6, 1962); Steffen, *The Private Placement Exception: What to Do About a Fortuitous Combination in Restraint of Trade,* 30 U. CHI. L. REV. 211 (1963); Note, *The Investment—Intent Dilemma in Secondary Transactions,* 39 N.Y.U.L. REV. 1043 (1964).

satisfied since, as a practical matter, a businessman is not going to accept stock without satisfying himself as to its issuer. The third requirement of a limited number of offerees presents more of a problem. Unlike the Uniform Securities Act, adopted by most states,[73] which specifically states the maximum number of offerees per year to stay within the private placement exemption, there is no set number of offerees in the federal law. In the celebrated *Ralston Purina Co.*[74] case, the Supreme Court looked not only at the number of offerees (some 400 employees per year) but also at their needs and circumstances. A long standing "rule of thumb" limits a "non-public" offering to twenty-five offerees.[75]

The second test, that of investment intent, is the requirement which presents the most serious hurdle in corporate acquisitions. Of course, the acquiring stockholder's intent is subjective, and it is usual for the corporation issuing the stock to receive a so-called "investment letter" from the recipient to the effect that the securities are being received for investment and not with the view of distribution. This representation of investment intent is often placed on the stock certificate as a legend to protect the issuing corporation —since it is the issuer and not the recipient who would violate the law.[76] While this legend flags the restriction, it will normally be removed after a reasonable period or in the event a proposed disposition would not require registration or a "no-action" letter was received from the SEC.

The question is what constitutes a reasonable holding period. How long must the holder keep the stock before it may be freely sold? Again, there is no specific amount of

[73] *E.g.*, OKLA. STAT. tit. 71, § 401(b)(9) 1965) (limits the non-public offering exemption to ten offerees during any period of twelve consecutive months).

[74] SEC v. Ralston Purina Co., 346 U.S. 119 (1953); Dulaney, *The Ways and Wherefores of Investment Letters*, 30 FORDHAM L. REV. 267 (1961); Note, *supra* note 72.

[75] 1 L. LOSS, *supra* note 72, at 662.

[76] Stark, *supra* note 1, at 1106.

time the stock must be kept. The recipient must by his actions demonstrate his investment intent. If circumstances surrounding the holding of the stock or the stockholder change, then the holder may normally sell the stock regardless of the time involved.[77] Of course, the holding period is, in fact, evidence of the intention of the recipient at the time of acquiring the security. Again, lawyers have used a two year holding period as rule of thumb and the SEC is reluctant to issue "no-action" letters in circumstances which involve a holding period of less than two years.[78]

While the "non-public" offering exemption is extremely helpful in acquiring corporations having a few stockholders, it is severely limited because of the limited offeree requirement. Thus, in acquisitions which qualify as reorganizations, the most frequently used exemption from registration under the Securities Act of 1933 is Rule 133 of the General Rules and Regulations under the Securities Act of 1933.[79] Rule 133 says that the issuance of securities pursuant to a merger, consolidation or acquisition of substantially all of the assets of a corporation is not a "sale" as the term "sale" is used in the Securities Act of 1933. To qualify under Rule 133, the merger, consolidation or sale of assets must be brought before a vote of the stockholders of the corporation who will receive the securities in accordance with the corporate laws of the state of incorporation. If, by corporate majority action, the transaction is authorized, then the individual stockholder has no choice about accepting the securities other than his rights of dissent and appraisal.[80]

[77] 1 L. Loss, *supra* note 72, at § 665; SEC Securities Act Release, *supra* note 72.

[78] Dulaney, *supra* note 74; Onick, *Non-Public Offerings of Corporate Securities—Limitations on the Exemption Under Federal Securities Laws,* 21 U. PITT. L. REV. 1 (1959); Stark, *supra* note 1, at 1108.

[79] 17 C.F.R. § 230.133 (1964). *See generally* 1 L. Loss, *supra* note 72, at 518 n. 187 (bibliography).

[80] Stark, *supra* note 1, at 1109.

In businessmen's language, this means that the "no sale" theory and the Rule 133 exemption will apply to Type A and Type C reorganizations but will not apply to Type B reorganizations. Of course, most Type B reorganization acquisitions find exemption under the "non-public" offering rule.

Rule 133, however, does not provide complete exemption in that the recipients of the stock issued pursuant to a corporate transaction may not freely sell the stock.[81] The constituent corporations to a reorganization or an affiliate of a constituent corporation—"affiliate" being defined as a person controlling, controlled or under the common control of a constituent corporation and in fact meaning, all officers, directors and holders of ten percent or more of the stock[82]—who receive the stock with the intention of resale are so-called statutory "underwriters."[83] They may not sell their stock without registration except as provided in Rule 133, which allows certain brokers transactions as set out therein and in Rule 154. These are the so-called "brokers transaction" without registration rules.

In order to protect the issuer from liabilities under the securities acts, it is normal for persons who might be affiliates to execute representations that the stock is not being acquired with a view to distribution except as permitted by the Securities Act of 1933. An appropriate legend on the face of the stock certificate is used.

While the exemptions to the securities regulations are complex, it is safe to say that many corporate acquisitions would not be consummated in their absence. The combination of the "tax free" reorganization sections of the Internal Revenue Code and the exemption provisions of the Securities

[81] 1 L. Loss, *supra* note 72, at 518; Purcell, *A Consideration of the No-Sale Theory Under the Securities Act*, 24 BKLYN. L. REV. 254 (1958).
[82] SEC Reg. 405, 17 C.F.R. § 203.405(2) (1963).
[83] SECURITIES ACT of 1933, § 2(11), 15 U.S.C. §§ 77a-aa (1964).

Act of 1933 should cause the businessman to realize that Congress does understand the problems of corporate acquisitions.

In every corporate acquisition there are numerous other areas of law to be considered. Of primary importance are state and local tax and securities regulatory problems. A purchase of assets necessarily involves bulk sales laws.[84] Publicly held corporations must concern themselves with stock exchange and proxy rules. The acquiring corporation should also consult its accountants to determine whether the proposed acquisition is to be treated as a "pooling of interests" or a "purchase."[85]

A corporate acquisition is a complex transaction. What has been discussed has necessarily been some of the fundamentals of corporation acquisitions.

[84] UNIFORM COMMERCIAL CODE art. 6.

[85] *Sale of a Corporate Business: A Panel Discussion, supra* note 1; *Tax Planning: Its relationship to Corporate Legal and Financial Problems, supra* note 14, at 903.