Structuring the Debtor Company Purchase/Sale Transaction

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The owner of a financially troubled debtor company may have to sell the company (1) to pay the company creditors and (2) to achieve sufficient liquidity to nurture remaining business opportunities. This liquidity event may be the only option available to either the individual owner or the corporate parent of the debtor company. In all cases, the structure of the debtor company sale and purchase will affect the income tax implications of the transaction. And, the income tax implications will affect the valuation (i.e., the pricing) of the proposed debtor company sale transaction. This discussion summarizes several common transaction structuring issues that will affect the planning for the debtor company sale and purchase transaction.

Introduction

For the owners of a financially distressed debtor company, the sale of the company may be the only available option that may generate sufficient liquidity to pay the company creditors and/or avoid liquidation.

This scenario may represent the only available liquidity option. This is because the current capital markets are very unfavorable to a financially distressed company that is attempting to raise capital—and particularly debt capital.

For the debtor-in-possession (DIP) of a company in bankruptcy, the sale of one or more of the debtor company business units may:

1. remove the underperforming operations from the bankruptcy estate,
2. generate cash to fund the remaining profitable business operations, and
3. lead to a successfully restructured or reorganized company.

Accordingly, the sale of the DIP business unit may help the debtor company improve its operating results. More importantly, given the current sluggishness of the capital markets (and particularly of the credit market), the sale of the debtor company may be the only practical way for the DIP to achieve liquidity.

In all cases, the sellers of the debtor company (or of a subsidiary or division of a debtor corporation) have to consider a basic transaction structure question. That basic structure question is: Should the proposed company sale transaction should be structured as:

1. a sale of assets or
2. a sale of stock.

This basic structuring consideration has legal, accounting, and taxation implications. And, all three of these implications (but especially the income tax effects) can influence the proposed transaction sale/purchase price.

Basic Transaction Structuring Considerations

Typically, the financially troubled company seller (whether a corporate seller or an individual seller) would prefer to sell the debtor company stock. With the sale of stock, most of the debtor company legal

liabilities transfer from the seller to the buyer. The financial accounting for the gain or loss on the sale of debtor company stock is typically less complex for the seller.

And, assuming the debtor company stock was owned for over one year, the seller typically recognizes capital gain (instead of ordinary income) on the taxable sale of the company stock.

Of course, typically, the troubled company buyer (whether a corporate buyer or an individual buyer) would prefer to buy the company assets. With the purchase of assets, most of the debtor company legal liabilities are retained by the seller (who still owns the debtor corporation stock).

For financial accounting purposes, there are usually fewer contingent liabilities that affect the buyer's purchase price allocation in an asset purchase transaction.

In addition, for income tax accounting purposes, with the purchase of company assets, the buyer gets to "step up" the tax basis in the acquired assets (versus having a "carryover" tax basis in the acquired assets).

This means that the buyer can depreciate or amortize (i.e., obtain an income tax deduction) for the entire purchase price paid for the assets—instead of for only the seller's old (and presumably depreciated) tax basis in the transferred assets. Of course, this tax benefit to the asset buyer typically results in ordinary income treatment—instead of capital gain treatment—to the asset seller.

In addition to the issue of the sale of stock versus the sale of assets, there are other transaction structuring issues related to the sale (and purchase) of a financially distressed debtor company. These issues should be considered by both the seller and the buyer.

Both the legal counsel and the valuation analyst/financial adviser should advise their respective buyer/seller clients with regard to these structuring issues. This is because these structuring issues have both legal implications and valuation (i.e., transaction price) implications.

These transaction structuring issues should be resolved through the process of the deal negotiations (presumably in the best interest of the bankruptcy estate, in the case of a debtor company in bankruptcy).

Once agreed upon by the transaction parties, these structuring issues should be clearly articulated in the transaction closing document (whether a stock sale agreement or an asset sale agreement).

This discussion summarizes the following three common troubled company sale transaction issues:

1. the inclusion of a seller noncompetition agreement
2. the inclusion of a seller consulting or continuing services agreement
3. the inclusion of goodwill in the transaction

In particular, this discussion focuses on the income tax implications of these three transaction issues—to both the troubled company seller and the troubled company buyer. As mentioned above, these issues (and the related income tax effects) have transaction valuation and pricing implications.

Three Common Debtor Company Sale Structuring Issues

Three transaction structuring issues are commonly considered when the owner is negotiating the sale of a financially troubled debtor company:

1. noncompete covenants
2. consulting agreements
3. goodwill

On the surface, the income tax treatment related to each of these transaction issues seems fairly straightforward. However, the specific wording of the subject stock or asset purchase agreement (or the lack of such a mention in the transaction documents) can create either income tax opportunities or income tax problems.

The following discussion summarizes (1) these three transaction structuring issues and (2) some of the areas for the parties (and their respective legal counsel) to consider when crafting the transaction agreements.

This discussion is intended to provide both the troubled company seller and the troubled company buyer with the most basic guidance so as to avoid transaction structuring pitfalls. The transaction parties should consult with their legal counsel and their tax advisers to obtain specific transaction structuring guidance.

First, the objective of a noncompetition covenant (or a separate noncompetition agreement) is to protect the buyer's interest in the newly acquired business. The noncompetition agreement can be granted by either:

1. the individual seller of the debtor company or
2. the corporate seller of the debtor company.

The purpose of the noncompete covenant is to ensure that the debtor company seller does not:

1. reestablish the individual seller or the corporate seller in the same geographical area or
2. compete with the debtor company buyer (i.e., the new owner of the subject business).

Second, consulting agreements are created when the debtor company buyer intends to retain the expertise of the individual seller of the debtor company for a period of time. With such an agreement, typically the individual seller will advise the individual buyer on operational and/or strategic matters during a specified transition period.

Alternatively, the business buyer may need the parent corporation seller of the debtor company to continue to provide financial accounting, research and development, and other "corporate" type services until the buyer company can develop its own expertise in such areas.

In this case, a service provider (or services) agreement is created when the business buyer intends to retain the parent corporation seller to provide specified services during a specified transition period.

Third, for income tax purposes, goodwill is defined in Regulations Section 1.197-2(b)(1) as "the value of a trade or business attributable to the expectancy of continued customer patronage. This expectancy may be due to the name or reputation of a trade or business or any other factor."

In a transaction that is the taxable purchase of going-concern business assets, goodwill is considered to be an Internal Revenue Code Section 197 intangible asset.

And, in an asset purchase, the business buyer can amortize the amount of the transaction purchase price allocated to goodwill over a 15-year amortization period.

Alternatively, in a transaction structured as a stock purchase, typically no amount of the transaction purchase price is allocated to goodwill. And, in a stock purchase, no goodwill amortization income tax deduction is available to the debtor company buyer.

Exhibit 1 summarizes the federal income tax implications of these three transaction structuring issues to both the debtor company seller and the debtor company buyer.

Exhibit 1
Federal Income Tax Implications of Three Debtor Company Sale/Purchase Transaction Structure Issues

Debtor Company Sale and Purchase Transaction Structure Issue:	Income Tax Considerations to the Debtor Company Seller	Income Tax Considerations to the Debtor Company Buyer
1. Noncompete covenant or noncompetition agreement	Ordinary income is recognized (but not subject to self-employment tax if the company seller is an individual)	The fair market value of the covenant may be amortized over a 15-year period
2. Personal consulting agreement or personal corporate services agreement	Ordinary income is recognized (but is subject to self-employment tax if the company seller is an individual)	A current period income tax deduction is available for the actual amounts paid to the sellers
3. Purchased goodwill	Capital gain is recognized (except if amortization deductions have already been taken, which are then recaptured as ordinary income under Section 197(f)(7))	Capital asset that may be amortized over a 15-year period in a taxable asset purchase (but may not e amortized in a stock purchase)

The Competing Economic Interests of the Company Buyer and the Company Seller

Under the current federal income tax rates, the debtor company seller (other than a C corporation) would typically prefer to allocate the transaction sale price to goodwill (as opposed to a noncompete agreement or to a consulting agreement).

With such a sale price allocation, the troubled company seller would benefit from capital gain tax treatment (assuming that the seller has owned the debtor company stock for more than one year).

Even ignoring the income tax considerations, the debtor company buyer (whether an individual buyer or a corporate buyer) is likely to want to protect his (or its) investment by ensuring that the seller does not immediately compete with the transferred business.

If the subject transaction is a stock sale (and not an asset sale), then the buyer will typically not be able to

amortize any of the purchase price premium as purchased goodwill. In such a debtor company sale structure, the buyer inherits the seller's carryover tax basis of the purchased debtor company assets.

Particularly in that scenario, the buyer will want to allocate a portion of the transaction purchase price to an amortizable noncompete agreement—and away from the nonamortizable acquired debtor company stock.

As mentioned above, the business buyer may also want to retain the selling parent corporation or the individual seller's personal services for a period of time. The debtor company buyer has the greatest preference to allocate the transaction purchase price to such a consulting agreement.

Such a purchase price allocation would result in a current income tax deduction to the debtor company buyer. In contrast, any transaction purchase price that is allocated to the noncompete agreement will be amortized over a 15-year amortization period.

From an individual seller's perspective, a sale price allocation to a noncompete agreement is generally preferable to a sale price allocation to a consulting agreement from an income tax standpoint. This is because any payments made under a consulting agreement will be subject to self-employment tax.

Self-employment income, however, does afford the debtor company individual seller the ability to establish a variety of tax-saving vehicles, including retirement plans and medical reimbursement plans. It is noteworthy that these tax saving vehicles generally need to be established within certain time limits. And, they cannot be established after the fact.

The Importance of Both Transaction Substance and Transaction Form

If both a noncompete covenant and a consulting agreement are contemplated in the debtor company sale transaction, then it is particularly important that both substance and form actually exist to support the respective transaction agreements.

To support the amount of value that is assigned to the noncompete agreement, the subject parties need to have competing economic interests. Furthermore, both the value of and the conditions of the noncompete agreement need to be realistic.

For example, it may be difficult for the debtor company buyer to argue that the individual seller will compete with the transferred debtor company if the individual seller:

1. does not have the financial ability,
2. is in poor health, or
3. retired immediately after the sale of the troubled business.

A classic example of a lack of competing economic interests is provided in the Tax Court judicial decision *Mackey's, Inc.*[1] In that case, the individual seller retained a majority ownership interest in the company that was sold. The individual seller also moved overseas within less than a month of signing the transaction sale documents.

The Tax Court found that the transaction noncompete covenant was invalid. This was because the noncompete covenant merely restricted the individual seller from competing against himself. The Tax Court also ruled the individual seller's consulting agreement to be invalid.

The Tax Court reached this decision because the individual seller did not perform any services for the company buyer.

The Tax Court held that the following payments were disguised dividends to the individual seller:

1. the noncompete covenant payments
2. the consulting agreement fees

Any existing debtor company agreements should also be reviewed to ensure that a conflict does not exist. For example, if a troubled fast-food restaurant franchise is being sold, the existing franchise agreement may prevent another franchise store from opening within a specified geography distance.

It would be difficult for a buyer to argue the validity of the franchise seller's noncompete covenant if the distance specified in the noncompete covenant was less than the distance in the already existing franchise agreement.

The noncompete covenant should also have provisions for breach of contract in the case that the debtor company seller fails to comply with the terms of the noncompete covenant. The Internal Revenue Service may argue that the lack of any breach of contract provision is indicative of disguised goodwill value—instead of noncompete covenant value.

By its nature, a consulting agreement presupposes that the debtor company seller will perform some sort of consulting services for the debtor company buyer. The objective of such a consulting agreement is to ensure an orderly ownership transition.

> "If both a noncompete covenant and a consulting agreement are included in the sale/purchase transaction structure, then it is important that they be distinguishable."

In order to have substance, the debtor company seller—as the consultant—will need to perform actual and meaningful consulting services to the transferred debtor company.

If both a noncompete covenant and a consulting agreement are included in the sale/purchase transaction structure, then it is important that they be distinguishable. That is, the two agreements should provide for specific payment allocations.

And, the two agreements should avoid any ambiguity so the Internal Revenue Service does not recharacterize the noncompete agreement as a consulting agreement—and, therefore, make the payments to the seller subject to self-employment tax.

The sale/purchase transaction participants may want to obtain a purchase price allocation valuation report from an independent valuation analyst. Such an independent valuation report provides an allocation of the overall purchase consideration to the various transaction pieces. This valuation report can be a valuable document to support the transaction purchase price allocation.

The Internal Revenue Code anticipates the parties' incentive to shift a transaction purchase price allocation away from a noncompete covenant and towards a consulting agreement.

The legislative history of Internal Revenue Code Section 197 directs any arrangement that "requires the former owner of an interest in a trade or business to continue to perform services (or to provide property or the use of property)" should be considered to have substantially the same effect as a noncompete covenant where the amount paid to the business seller pursuant to the noncompete covenant exceeds the amount that represents "reasonable compensation for the services actually rendered (or the property or use of property actually provided)."

Summary and Conclusion

When an individual or a corporate troubled company owner decides to sell the debtor company, that seller wants to receive the greatest amount of sale proceeds, after considering the transaction tax consequences.

When an individual or corporation decides to buy the troubled company, the buyer wants to pay the lowest possible purchase price, after considering the transaction tax consequences. The structure of the debtor company sale/purchase can have a direct impact on the transaction income tax ramifications—and, therefore, on the proposed transaction price.

Of course, all transaction participants should consult their respective legal counsel and tax advisers regarding the legal and income tax implications of the proposed transaction structure. And, all transaction participants should also consult with their respective financial advisers regarding the valuation (i.e., pricing) implications of the transaction structure.

From the seller's perspective, the debtor company sale should allow the seller:

1. to pay creditors and
2. to achieve liquidity in order to nurture any remaining successful business units.

From the buyer's perspective, the debtor company purchase should allow the buyer:

1. to restructure the financially troubled company into a successful business enterprise and
2. to earn a fair return on the purchase price investment.

Both the substance and the form of the deal are important when the respective legal counsel are crafting the transaction documents related to the sale of a troubled business. For income tax purposes, the Internal Revenue Service and the courts will look beyond the written word to confirm that the parties' actions actually support the purchase/sale transaction agreements.

Where the parties' actions do not support the purchase/sale transaction agreements, the Service may recharacterize the nature of the stock or asset transaction payments. And, such a recharacterization can materially change the economics of the debtor company sale/purchase transaction to the buyer, to the seller, or to both.

Notes:

1. T.C. Memo. 1975-280 (Sept. 8, 1975).

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