Transaction Structure Issues Regarding the Purchase/Sale of a Financially Distressed Company

Katherine A. Gilbert

A merger or acquisition (M&A) transaction involving a financially distressed company can be structured as either a stock sale/purchase or an asset sale/purchase. Depending on the transaction structure, such acquisitive transactions may include noncompete covenants or noncompetition agreements, consulting services agreements, and/or acquired goodwill. The structure of the subject company sale transaction has income tax implications that may affect the sale/purchase price of the distressed company. This discussion focuses on (1) several common transaction structuring issues and (2) the income tax implications for both the seller and the buyer of the distressed company.

Introduction

The sale of a financially distressed company may be the only option available to allow the company owners to generate sufficient liquidity to (1) pay the company's creditors and/or (2) prevent the entity's insolvency and possibly a bankruptcy proceeding.

Therefore, the sale of all (or a business unit) of the financially distressed company may be the last resort for owners of an entity operating in or near the zone of insolvency.

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

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

Accordingly, the DIP sale of an underperforming business unit may help the remaining debtor company to improve its operating results—and ultimately to reorganize out of bankruptcy protection.

In all cases, the sellers of the financially distressed company (or of a subsidiary or other business unit of the distressed company) will have to consider if the proposed transaction should be structured as a sale of the company assets or a sale of the company stock.

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

Company Transaction Structuring Considerations

In general, the seller of a financially distressed company (whether a corporate seller or an individual seller) would prefer to sell the stock of the company. With the sale of the troubled company stock, most of the company's legal liabilities transfer from the seller to the buyer.

In addition, the financial accounting for the gain or loss on the sale of the company stock is typically

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less complex for the seller. And, assuming that the company stock was owned for more than one year, the seller typically recognizes a capital gain (instead of ordinary income) on the taxable sale of the troubled company stock.

On the other hand, the buyer of the distressed company (whether a corporate buyer or an individual buyer) would prefer to buy the company assets. With the purchase of the troubled company assets, most of the company's legal liabilities are retained by the seller (who still owns the company stock).

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

Furthermore, with the purchase of the troubled company assets, for federal income tax purposes, the buyer gets to "step up" the income tax basis in the acquired assets—versus having to record a "carryover" income tax basis in the acquired assets.

Of course, this income tax benefit to the asset buyer typically subjects any gain on the asset sale to ordinary income treatment—instead of capital gain treatment—to the asset seller.

In addition, there are other restructuring issues related to the sale of the stock of a financially distressed company. These issues should be considered by the legal counsel and the valuation analyst/financial adviser representing both the seller and the buyer. This is because these transaction structuring issues have both legal implications and valuation (i.e., transaction price) implications.

In the case of a debtor company in bankruptcy, these transaction structuring issues should be resolved through the process of the deal negotiations, presumably in the best interest of the bankruptcy estate. Once agreed upon, these transaction structure issues should be clearly articulated in the transaction closing document (whether that document is a stock sale agreement or an asset sale agreement).

Three Common Transaction Structuring Issues

Three transaction structuring issues commonly arise whether the owner is negotiating the sale either of the entire financially distressed business or of a business unit of the distressed company:

1. Noncompete covenants
2. Consulting agreements
3. Business goodwill

At first glance, the income tax treatment related to each of these transaction structure issues seems fairly straightforward. However, the specific wording of the subject stock or asset purchase agreement (or the lack of any such specific wording) can create either income tax opportunities or income tax problems.

The following discussion presents an overview of these three transaction structuring issues. This discussion also summarizes some of the areas for the transaction parties to consider when drafting the purchase/sale transaction agreements.

This discussion is intended to provide both the distressed-company seller and the distressed-company buyer with factors to consider so as to avoid some common 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 deal document 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 distressed company or
2. the corporate seller of the distressed company.

The purpose of the noncompete covenant is to ensure that the distressed company seller (whether individual or corporate) does not:

1. reestablish itself in the same line of business in the same geographical area or
2. otherwise compete with the distressed company buyer (i.e., the new owner of the subject business).

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

Alternatively, the troubled company buyer may wish to retain the services of the corporate business

seller for a period of time. In this case, a services provider agreement (often called a services agreement) is created when the troubled company buyer intends to retain the corporate seller to provide specified services during a specified transition period.

For instance, the buyer of the distressed business unit may need a DIP corporation seller to continue to provide financial accounting, research and development, data processing, regulatory compliance, and other "corporate" type services to the transferred business unit until the buyer company can develop its own expertise in such areas.

Third, for federal income tax purposes, goodwill is defined in Treasury regulation 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 the assets of a going-concern business, goodwill is considered to be an Internal Revenue Code Section 197 intangible asset. The buyer of the troubled company can amortize the amount of the transaction purchase price allocated to the acquired goodwill over a 15-year period.

However, in a stock purchase transaction, no amount of the troubled company transaction purchase price is typically allocated to goodwill. And, therefore, no income tax deduction is available to the troubled company buyer with regard to the amortization of the acquired goodwill.

Table 1 summarizes the federal income tax implications of these three transaction structuring issues to both (1) the distressed company seller and (2) the distressed company buyer.

Competing Economic Interests of the Company Buyer and the Company Seller

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

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

Even ignoring the income tax considerations, the troubled company buyer is likely to want to protect his (or its) investment by ensuring that the troubled company seller does not immediately compete with the transferred business. If the subject transaction is a stock sale and not an asset sale, then the troubled company buyer will not be able

Table 1
Federal Income Tax Implications of the Acquisition Transaction Structure

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

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to amortize any purchase price premium as purchased goodwill.

In such a company sale structure, the buyer inherits the seller's carryover tax basis in the purchased company assets. Particularly in that scenario, the company buyer will want to allocate the transaction purchase price to an amortizable noncompete agreement—and away from the nonamortizable acquired company stock.

As mentioned above, the troubled company buyer may also want to retain the selling parent corporation's administrative services or the individual seller's personal services for a period of time. The company buyer has the greatest income tax 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 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, an allocation to a noncompete agreement is generally preferable to an allocation to a consulting agreement from an income tax standpoint. This preference is because any payments made under a consulting agreement will be subject to self-employment tax.

Self-employment income, however, does afford the individual seller with 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, such benefit-related plans cannot be established after the fact (i.e., after the subject business sale).

The Importance of Transaction Substance and Transaction Form

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

In order to support the fair market value assigned to the noncompete agreement, the subject transaction parties need to have competing economic interests. Furthermore, both the fair market value and the conditions of the noncompete agreement should be realistic.

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

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

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

The Tax Court concluded 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 concluded that the individual seller's consulting agreement was invalid. The court reached this conclusion because the individual seller did not perform any services for the company buyer.

In the *Mackey's, Inc.*, decision, the Tax Court concluded that the following payments were disguised dividends to the individual seller:

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

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

It would be difficult for the franchise 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 event that the business seller fails to comply with the terms of the

noncompete covenant. The Internal Revenue Service ("the 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 troubled company seller will perform some sort of consulting services for the troubled company buyer, so as to ensure an orderly ownership transition. In order to have substance, the company seller—as the consultant—will need to perform some actual and meaningful consulting services to the transferred 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 different. That is, the two agreements should provide for specific payment allocations.

And, the two agreements should avoid any ambiguity so the Service does not recharacterize the noncompete agreement as a consulting agreement. This recharacterization would make the contractual payments to the company seller to be subject to self-employment tax.

The distressed company seller/buyer 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. Such a 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 toward a consulting agreement.

The legislative history of Internal Revenue Code Section 197 directs taxpayers that any contractual 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)" is considered to have substantially the same effect as a noncompete covenant where the amount paid to the business seller pursuant to such arrangement 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 owner or corporate owner of a financially troubled company decides to sell that company, the owner wants to receive the greatest amount of net sale proceeds, after considering the transaction income tax consequences. When an individual or corporation decides to buy the troubled company, the buyer wants to pay the lowest amount of net purchase price after considering the transaction income tax consequences.

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The structure of the financially troubled company sale/purchase can have a direct impact on the transaction income tax ramifications and, therefore, on the transaction purchase price.

Of course, the deal participants should consult with legal counsel regarding the legal implications of the transaction structure. The deal participants should also consult with their financial advisers regarding the valuation implications of the transaction structure.

From the seller's perspective, the troubled company sale should allow the seller to pay creditors, avoid a bankruptcy filing, and have liquidity so as to nurture any remaining successful business units.

From the buyer's perspective, the troubled company purchase should allow the buyer to restructure the financially troubled company into a successful business enterprise and to earn a fair return on the acquisition investment.

Both the substance and the form of the deal are important with respect to drafting the transaction documents related to the company sale. For income tax purposes, both the Service and the courts will look beyond the written word to confirm that the parties' actions actually support the transaction agreements.

Where the parties' actions do not support the transaction agreements, the Service may recharacterize the transaction payments. Such an income tax recharacterization can materially change the economics of the financially troubled company sale/purchase transaction.

Note:

1. T.C. Memo. 1975-280.

Katherine Gilbert is a manager in our Atlanta office. She can be reached at (404) 475-2312 or at kagilbert@willamette.com.