DMA
ACCOUNTANCY CORPORATION

Understanding how taxes factor into an M&A transaction

Merger and acquisition activity has been brisk in recent years. If your business is considering merging with or acquiring another business, it's important to understand how the transaction will be taxed under current law.

Stocks vs. assets

From a tax standpoint, a transaction can basically be structured in two ways:

1. Stock (or ownership interest). A buyer can directly purchase a seller's ownership interest if the target business is operated as a C or S corporation, a partnership, or a limited liability company (LLC) that's treated as a partnership for tax purposes.

The now-permanent 21% corporate federal income tax rate under the Tax Cuts and Jobs Act (TCJA) makes buying the stock of a C corporation somewhat more attractive. *Reasons*: The corporation will pay less tax and generate more after-tax income. Plus, any built-in gains from appreciated corporate assets will be taxed at a lower rate when they're eventually sold.

The TCJA's reduced individual federal tax rates may also make ownership interests in S corporations, partnerships and LLCs more attractive. *Reason*: The passed-through income from these entities also will be taxed at lower rates on a buyer's personal tax return. However, the TCJA's individual rate cuts are scheduled to expire at the end of 2025, and, depending on future changes in Washington, they could be eliminated earlier or extended.

2. Assets. A buyer can also purchase the assets of a business. This may happen if a buyer only wants specific assets or product lines. And it's the only option if the target business is a sole proprietorship or a single-member LLC that's treated as a sole proprietorship for tax purposes.

Note: In some circumstances, a corporate stock purchase can be treated as an asset purchase by making a "Section 338 election." Ask your tax advisor for details.

Buyer vs. seller preferences

For several reasons, buyers usually prefer to purchase assets rather than ownership interests. Generally, a buyer's main objective is to generate enough cash flow from an acquired business to pay any acquisition debt and provide an acceptable return on the investment. Therefore, buyers are concerned about limiting exposure to undisclosed and unknown liabilities and minimizing taxes after the deal closes.

A buyer can step up (increase) the tax basis of purchased assets to reflect the purchase price. Stepped-up basis lowers taxable gains when certain assets, such as receivables and inventory, are sold or converted into cash. It also increases depreciation and amortization deductions for qualifying assets.

Meanwhile, sellers generally prefer stock sales for tax and nontax reasons. One of their main objectives is to minimize the tax bill from a sale. That can usually be achieved by selling their ownership interests in a business (corporate stock or partnership or LLC interests) as opposed to selling business assets.

With a sale of stock or other ownership interest, liabilities generally transfer to the buyer and any gain on sale is generally treated as lower-taxed long-term capital gain (assuming the ownership interest has been held for more than one year).

Keep in mind that other issues, such as employee benefits, can also cause unexpected tax issues when merging with, or acquiring, a business.

Professional advice is critical

Buying or selling a business may be the most important transaction you make during your lifetime, so it's important to seek professional tax advice as you negotiate. After a deal is done, it may be too late to get the best tax results. Contact us for the best way to proceed in your situation.

Call us at (714) 462-5290