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Some strategies for liquidating in a tax-efficient manner an interest in a closely held business, real estate, or a private investment fund

1. Liquidate interest in closely held company, and defer the income tax on the sale, by selling shares to an ESOP

2. Allocate some of the proceeds from the sale of a business operated through a C corporation directly to the shareholders, for their personal goodwill

3. Enable owner-managers of a business to be sold ("Target") to sell the business mostly for cash (taxable) but roll over part of their ownership interests in Target for ownership interests in the new operating entity ("Newco"), tax-deferred

4. When selling an S corporation ("Target-SCo") to a C corporation ("Buyer"), use an election under Internal Revenue Code § 338(h)(10) to enable Buyer to purchase Target-SCo's shareholders' shares rather than purchase Target-SCo's assets and yet get a stepped-up tax basis for Target-SCo's assets (as though Buyer had purchased Target-SCo's assets) without triggering two levels of income tax, while preserving for Target-SCo's shareholders the same net after-tax result they would have realized if for income tax purposes the transaction had been treated as a sale of stock

5. Where a client is selling a business whose assets include contracts to perform services for customers, support the seller's claim that the gain from the sale is taxable at the lower rates for capital gains, by properly structuring the sale

6. Hold each piece of real property in a separate non-disregarded-entity LLC to improve client's claim that he (or each LLC) holds the property as an "investor" rather than "dealer" and so (when he sells it) may pay tax at the lower rates for capital gain

7. Enable investors in a maturing private investment fund to exit either for cash (taxable) or for interests in a successor fund (tax-deferred)

[See following pages for a brief discussion of each idea listed above]

1. Liquidate interest in closely held company, and defer the income tax on the sale, by selling shares to an ESOP

An owner of a closely-held company (a C corporation, not an S corporation or a partnership) can use a leveraged ESOP to create a market for his shares and can sell to the ESOP without incurring immediate taxable gain.

An ESOP (employee stock ownership plan) is an employee benefit plan designed to invest primarily in the sponsoring company's stock, thereby giving the participating employees an ownership stake in their employer. It is similar in many ways to a profit-sharing plan. A leveraged ESOP acquires shares of the company's stock using borrowed funds. The company then makes cash contributions to the ESOP to enable it to repay the loan. The company's contributions to the ESOP are generally tax-deductible.

An owner who sells shares to an ESOP can often postpone any income tax that would otherwise be due on the sale by reinvesting his proceeds in shares (or certain other securities) of another operating company or companies ("replacement shares"), even publicly traded shares in blue chip companies (but not a mutual fund), effectively substituting a diversified blue chip portfolio for his closely-held stock, all without current income tax on the gain. In general, he can defer the income tax until he sells the replacement shares. For a company's founder, and for any other owner with little or no tax basis in his shares, this "rollover" rule can provide an extraordinary tax planning opportunity.

The selling owner need not sell to the ESOP his entire interest in the company. He can sell a portion and keep the rest, thereby liquidating part of his interest (on a tax-deferred basis) without relinquishing control of the company.

2. Allocate some of the proceeds from the sale of a business operated through a C corporation directly to the shareholders, for their personal goodwill

Advantageous where the business to be sold is operated through a C corporation (or an S corporation that has built-in gain from periods when it was a C corporation), to reduce the double tax (upon a sale of the assets of a C corporation, the sale proceeds would be subject to income tax at the level of the corporation and again when distributed from the corporation to the shareholders).

If the owners work in the business and the business is dependent on the employee-owners' personal skills and relationships (for example, with customers or suppliers), the owners may be able to treat a portion of the sale proceeds as being for their personal goodwill rather than goodwill belonging to the entity. That part of the proceeds would be taxable only once (to the selling shareholders), and at the usually-lower tax rates for long term capital gain.

3. Enable owner-managers of a business to be sold ("Target") to sell the business mostly for cash (taxable) but roll over part of their ownership interests in Target for ownership interests in the new operating entity ("Newco"), tax-deferred

In other words, enable the owners of Target to retain an equity interest in Target's business (in the form of an equity interest in Newco) without using after-tax dollars.

To illustrate: X and Y own and manage Target, a limited liability company or an S corporation. Fund (a private equity fund) forms a limited liability company (Newco) to acquire the assets of Target. Newco pays Target 90% of the purchase price in cash and 10% in the form of ownership units in Newco. After the transaction, Target will liquidate, distributing to X and Y the cash proceeds and the 10% equity interest in Newco, except that if Target is an S corporation (rather than an LLC treated for tax purposes as a partnership), Target will retain the equity interest in Newco (for the benefit of X and Y as its shareholders), since unlike an LLC, an S corporation cannot distribute the equity interest to X and Y without triggering immediate recognition of gain. X and Y will continue to run the business (now as employees of Newco and subject to the oversight of Newco's managers and the Fund). Newco funds the purchase of Target's assets using (for 90% of the purchase price) equity cash from Fund (contributed to Fund by Fund's investors) and cash borrowed by Newco from a third-party lender, and (for 10% of the purchase price) the 10% equity interest in Newco issued to Target.

The parties' principal tax objectives are: (i) Newco seeks a step-up in tax basis for 90% of Target's assets (the portion acquired for cash) and is willing to accept a carryover basis for 10% of Target's assets (the portion acquired for the 10% equity interest in Newco); (ii) Target and its owners (X and Y) are content with a mostly taxable transaction, except that X and Y wish to roll over part of their interests in Target into a 10% interest in Newco, tax-deferred (with the understanding that their initial basis in their 10% interest in Newco will probably be zero, since their initial basis in that 10% interest will equal their pre-sale basis in their shares in Target, reduced by the cash proceeds distributed to them from Target); (iii) the parties wish to allocate the step-up in basis of Target's assets (that is, the amount by which the cash portion of the purchase price exceeds Target's pre-sale tax basis in its assets) to goodwill / going-concern value, so that that portion of the cash purchase price will be eligible for capital gain tax rates to the sellers and 15-year amortization deductions for Newco.

4. When selling an S corporation ("Target-SCo") to a C corporation ("Buyer"), use an election under Internal Revenue Code § 338(h)(10) to enable Buyer to purchase Target-SCo's shareholders' shares rather than purchase Target-SCo's assets and yet get a stepped-up tax basis for Target-SCo's assets (as though Buyer had purchased Target-SCo's assets) without triggering two levels of income tax, while preserving for Target-SCo's shareholders the same net after-tax result they would have realized if for income tax purposes the transaction had been treated as a sale of stock

For non-tax reasons (for example, to avoid the need to get third parties to consent to Target-SCo transferring its licenses, contracts, etc.), it may be advisable for Buyer to purchase Target-SCo's shareholders' shares rather than to purchase Target-SCo's assets. But, a stock purchase (in itself) would not result in a stepped-up tax basis for Target-SCo's assets.

To enable Buyer to achieve the desired step-up in the basis of Target-SCo's assets and to accomplish that without triggering two levels of income tax, Buyer may want the parties to elect, under Code § 338(h)(10), for income tax purposes to treat the sale of stock as a sale of assets; that is, treat Target-SCo as selling its assets (while it is still an S corporation) and distributing the proceeds from that deemed sale to Target-SCo's shareholders.

Even though Target-SCo and its shareholders will not incur two levels of income tax, Target-SCo's shareholders will not necessarily be indifferent as to whether for tax purposes the transaction is treated as a sale of their shares in Target-SCo or as a sale of Target-SCo's assets. In many cases, a § 338(h)(10) election will cause Target-SCo's shareholders to incur more income tax than they would have if the transaction were treated for income tax purposes as a sale of their stock. For one thing, a shareholder's gain on a sale of shares with no § 338(h)(10) election is capital gain ("CG") in its entirety, whereas a transaction treated as a sale of Target-SCo's assets will likely generate part CG and part ordinary income ("OI"), since not all of Target-SCo's assets are likely to be capital assets and since even a sale of a capital asset may trigger some OI recapture of accelerated cost-recovery deductions. There may be additional reasons why a particular shareholder would have less tax if the transaction were treated as a sale of his stock. For example, he may have a high tax basis in his shares (for example, because he recently purchased the shares at fair market value or he recently inherited the shares from a deceased shareholder and took a stepped-up tax basis equal to the shares' date-of-death value). Or, it may be that a sale of his shares would result in lower state income taxes, if he lives in a state other than Target-SCo's home state and his home state has lower state income tax rates or if Target-SCo is subject to state income tax in more than one state and the average rates of those states are higher than the rate of the shareholder's home state. So, Buyer may need to make a make-whole payment to Target SCo's shareholders: that is, pay them such additional amount as is necessary to put them in the same position (after taxes, including taxes on the make-whole payment) as they would have been in had the transaction been treated for tax purposes as a sale of their stock.

5. Where a client is selling a business whose assets include contracts to perform services for customers, support the seller's claim that the gain from the sale is taxable at the lower rates for capital gains, by properly structuring the sale

Claim that most of the sale price is for goodwill (the expectancy of customers' continued patronage) and going-concern value (both of which are taxable at the rates for capital gain) rather than for the existing service contracts in themselves (taxable at rates applicable to ordinary income).

To support that claim, require the buyer to expressly allocate most of the purchase price to goodwill. In addition, in the purchase agreement, (i) emphasize that the buyer is buying not just the existing service contracts but the business as a whole, including trade names and trademarks, goodwill, records, confidential information, the opportunity to hire the existing employees, etc., and (ii) list the customer contracts as simply one item among many in the definition of the assets being sold. Since under Internal Revenue Code § 197 the buyer can amortize goodwill and going-concern value over the same 15-year period that it could amortize other so-called "customer-based intangibles" (such as service contracts), the buyer should not object to allocating the purchase price primarily to goodwill. Defending an allocation to goodwill (against an IRS claim that the company's contracts with its customers have a value separable from the value of the business' goodwill) is easier where the contracts have a short term and the client relies on voluntary renewals.

6. Hold each piece of real property in a separate non-disregarded-entity LLC to improve client's claim that he (or each LLC) holds the property as an "investor" rather than "dealer" and so (when he sells it) may pay tax at the lower rates for capital gain

Help a client ("TP") who invests in real estate to look more like an "investor" and less like a "dealer" (to increase the likelihood that gains from sales of properties will be treated as capital gains rather than ordinary income), by using a separate limited liability company ("LLC") to acquire (and hold and sell) each separate piece of property, such LLC to be a pass-through entity but not a disregarded entity.

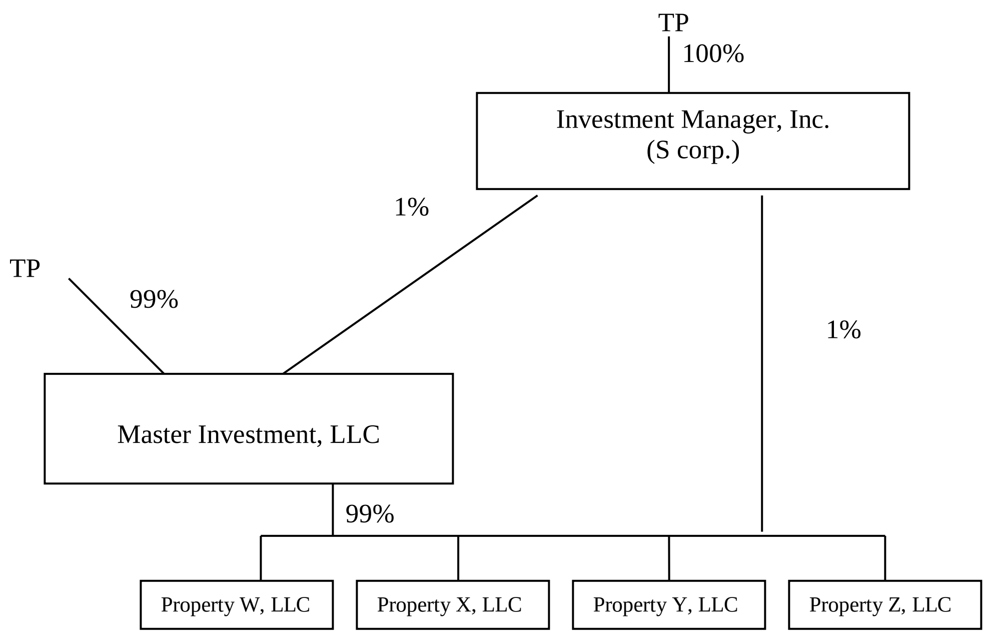
This technique may be useful for:

(i) a developer who also engages in investment activity, to (i) help separate the properties held for development (as to which he will be considered a "dealer") from the properties held for investment, and (ii) as to the properties held for investment, to avoid multiple sales by the same "tax person" (or entity); and

(ii) a person (or an investment fund) that does not develop real estate but that acquires (and eventually re-sells) multiple properties. This technique should improve his claim that he holds the properties "for investment," by avoiding multiple sales by the same "tax person" (or entity). (The number and frequency of sales is a key factor in determining whether a person is holding property as a "dealer" rather than "for investment.")

Although in some cases courts have refused to give much weight to the separate status of each property-holding LLC (for example, some courts have attributed to an entity the development activities of its owners), in other cases courts have respected the entities as separate.

To illustrate the technique in the case of a person ("TP") who engages in both development and investment activities: For his investment activities, TP might form an S corporation ("Investment Manager, Inc.") owned 100% by TP, and an LLC ("Master Investment, LLC") owned 99% by TP and 1% by Investment Manager, Inc. Then, for each piece of real property, form a separate LLC (for example, "Property X, LLC," "Property Y, LLC," etc.) to acquire and hold (and eventually re-sell) the property. Putting the investment properties into this structure would mark them off from TP's development properties. To avoid multiple sales by the same tax person or entity, each of the direct-property-owning LLCs (that is, Property X, LLC, Property Y, LLC, etc.) should not be a disregarded entity. So, rather than being owned 100% by Master Investment, LLC (or 100% by TP himself), each should be owned 99% by Master Investment, LLC and 1% by Investment Manager, Inc. See the following diagram:



A similar arrangement can be used by a private investment partnership ("fund"), not to segregate development properties from investment properties (there being no development properties) but simply to avoid multiple sales by the same tax entity. Rather than the fund acquiring its real properties directly, it would acquire each one through a separate LLC (Property X, LLC, Property Y, LLC, etc.) owned 99% by the fund and 1% by the fund's general partner.

7. Enable investors in a maturing private investment fund to exit either for cash (taxable) or for interests in a successor fund (tax-deferred)

Where a maturing private investment partnership ("Maturing Fund") has assets (for example, equipment) desired by another fund ("New Fund") and some of the investors (limited partners, or "LPs") in Maturing Fund wish to continue their investment in such equipment but others wish to convert their investment to cash, give Maturing Fund's LPs a choice of exits, with different income tax results.

A non-tax-efficient choice of exits would be for (i) New Fund to purchase Maturing Fund's equipment entirely for cash, (ii) Maturing Fund to distribute that cash pro rata to all of its LPs in a complete liquidation, and (iii) some Maturing Fund LPs to use that cash to purchase interests in New Fund. Under this approach, all of Maturing Fund's LPs would incur immediate income tax, even those who did not want to liquidate their investment.

The following approach confines the recognition of taxable income to those investors who want to sell for cash. In effect, some LPs exchange their interests in Maturing Fund for interests in New Fund, on a tax-deferred basis, and other LPs have their units in Maturing Fund liquidated for (taxable) cash, in separate transactions:

Transaction #1: Maturing Fund transfers an undivided fractional interest in its equipment to New Fund in exchange for units of ownership interest in New Fund ("Units"). Maturing Fund then distributes those Units in New Fund to its LPs who have elected to participate in Transaction #1 ("Exchanging LPs"), in liquidation of the Exchanging LPs' units in Maturing Fund. In effect, each Exchanging LP exchanges his units in Maturing Fund for Units in New Fund.

Transaction #2: After completing Transaction #1, Maturing Fund sells its remaining undivided fractional interest in its equipment to New Fund for cash, and distributes the cash proceeds of the sale to the GP and the remaining LPs ("Liquidating LPs"), in a complete liquidation of Maturing Fund. In effect, each Liquidating LP realizes results similar to the results he would have realized if Maturing Fund had sold all of its equipment for cash and then liquidated.

Participating in Transaction #1 should not cause the Exchanging LPs to recognize any taxable income. Each Exchanging LP will for federal income tax purposes have an initial basis in his Units in New Fund equal to the tax basis that he had in his units in Maturing Fund, and New Fund will have an initial federal income tax basis in the portion of the equipment acquired by New Fund in Transaction #1 equal to the tax basis that Maturing Fund had in that portion of the equipment. Participating in Transaction #2 will cause each Liquidating LP to recognize income equal to his allocable share of the income recognized by Maturing Fund on its sale of its remaining interest in the equipment, just as he would have done in connection with any other liquidating sale.

An alternative approach (likewise permitting the LPs in Maturing Fund to choose either to be cashed out (taxable) or to trade into an interest in New Fund on a tax-deferred basis), in which Maturing Fund could transfer its assets to New Fund in a single transfer, could be as follows (in this example, Maturing Fund holds a tract of undeveloped land ("Land"), and New Fund proposes to develop the Land):

- Maturing Fund transfers the Land to New Fund, and New Fund issues units of ownership interest in New Fund ("Units") to Maturing Fund in exchange for the Land. Maturing Fund distributes the Units in New Fund to all of Maturing Fund's owners (including the LPs) on account of their interests in Maturing Fund.

- New Fund subsequently buys the cashing-out LPs' Units in New Fund, for cash. Those of the LPs that elect rollover retain their Units in New Fund.

This rollover/cashout opportunity should enable the LPs not only to have a choice of exits from their investment in Maturing Fund but also to attain income tax results appropriate to their chosen exit, that is, exit for cash (taxable) or for an interest in New Fund (tax-deferred): Participating in the cashout transaction will cause each cashing-out LP to recognize taxable income at the time of the cashout. Since the cashing-out LPs will be selling their Units in New Fund directly to New Fund (as Units directly owned by the cashing-out LPs), the parties should be able to allocate the taxable gain from that sale entirely to the cashing-out LPs and none to the rolling-over LPs. As for the rolling-over LPs, they should not be required to recognize taxable income from participating in the rollover transaction Each of them will for federal income tax purposes have an initial tax basis in his Units in New Fund equal to the tax basis that he had in the portion of his interest in Maturing Fund. Consistent with that, New Fund will have an initial federal income tax basis in the portion of the Land acquired by New Fund for the rollover New Fund Units equal to the tax basis that Maturing Fund had in the Land.