TAX CONSIDERATIONS IN STRUCTURING

This article discusses the direct tax consequences associated with the decision to sell company assets compared to company stock for closely held construction companies.

THE SALE OF THE CLOSELY HELD CONSTRUCTION COMPANY

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When the owners of a closely held construction company decide to sell the corporation, they can either sell the company stock or sell the company assets. There are tax, legal, and other consequences associated with this business sale structuring decision. Of course, the construction company sellers should consult legal counsel to consider all of the legal consequences of a stock sale structure versus an asset sale structure. This discussion summarizes the tax consequences of structuring the construction company sale. To simplify this discussion, let's assume that the subject construction company is a regular C corporation.

Asset sale versus stock sale transaction structure

The sale of the construction company assets typically first results in the recognition of gain or loss (on the sale of the individual assets) at the corporation level. Then, the corporation still has to distribute the after-tax asset sale proceeds to the construction company stockholders. The distribution of the sale proceeds is also a taxable event, this time to the individual stockholders. Therefore, the asset sale transaction structure typ-

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ically results in double taxation, once at the corporation level and once again at the stockholder level.

Unlike the construction company asset sale transaction, a taxable stock sale structure does not result in the recognition of taxable income (or loss) at the corporation level. The difference between the tax basis and the fair market value (FMV) of the corporation's assets is deferred instead of recognized immediately. Unlike in the stock sale structure, those individual asset gains or losses are recognized immediately in the construction company asset sale structure.

In the construction company stock sale structure, the selling shareholders may recognize taxable gain on the sale of their shares. However, the double taxation problem (i.e., the tax on the sale of assets and the tax on the distribution of the sale proceeds) is deferred. This double taxation ultimately becomes the responsibility of the construction company buyer (at least for the corporate portion of the double taxation).

IN ANY PARTICULAR CONSTRUCTION COMPANY SALE, THE NONTAX TRANSACTION ISSUES MAY DICTATE THE PREFERENCE FOR AN ASSET SALE STRUCTURE OR A STOCK SALE STRUCTURE.

The construction company's tax attributes could include a net operating loss (or NOL), a capital loss, a tax credit carryover, and certain built-in losses. In the taxable stock sale transaction, these company tax attributes are transferred to the company buyer. However, under Sections 382 and 383, these construction company tax attributes may be subject to severe use restrictions after a corporate ownership change. In the asset sale transaction, the selling corporation's tax attributes remain the property of the construction company seller. These seller corporation's tax attributes may be used to offset the seller corporation's income and gains resulting from the construction company asset sale.

In any particular construction company sale, the nontax transaction issues may dictate the preference for an asset sale structure or a stock sale structure. Of course, such transaction issues include numerous legal issues, as well as the buyer's preferences. Construction company acquirers generally try to avoid acquiring the seller corporation's stock. This is because the target corporation may have contingent or undisclosed liabilities that the corporate purchaser will inherit if the target's stock is acquired. However, if a target construction company has valuable non-assignable assets (such as a license agreement or a favorable lease), acquiring the target's stock may be more appealing to the corporate purchaser.

Pros and cons of alternative transaction structures

For a selling shareholder, a taxable stock sale transaction structure (as opposed to an asset sale by the corporation or a tax-free reorganization) typically makes sense in situations where:

1. the double taxation will erode the cash proceeds that the seller nets from an asset sale by the target company followed by a liquidation of the target company;
2. the seller can shelter the gains from the stock sale with an NOL or a capital loss carryover;
3. the seller can recognize a loss (perhaps an ordinary loss under Section 1244, as discussed below) on the sale of the target construction company stock; and
4. a tax-free reorganization is unattractive because the company seller wants cash or a limited market exists for the stock of the acquiring corporation.

For the construction company buyer, a taxable stock purchase typically makes sense in situations where:

1. the target construction company holds depreciated assets (i.e., the asset tax basis is greater than the asset FMV), so the issue of stepping up the basis of the acquired assets is not applicable;
2. the target company's tax attributes have value even after application of the Sections 382 and 383 limitation rules. If the construction company buyer makes a direct asset purchase, the target company tax attributes do not transfer to the buyer;
3. unwanted assets and/or unknown or contingent liabilities are unimportant to the construction company buyer; and

4. the target company has many assets, making the transfer of the titles to those assets a complex and costly matter, or the target company has favorable contracts, permits, or leases that are non-assignable.

The tax consequences to the seller

If the construction company stock was held for more than 12 months, its sale usually generates a long-term capital gain or loss for the selling shareholder. If the construction company stock is sold at a gain, the seller may be able to exclude some of the gain under Section 1202. If the construction company stock is sold at a loss, the seller can treat some or all of a loss as an ordinary loss rather than as a capital loss under Section 1244.

In a stock sale for cash structure, the seller recognizes gain or loss equal to the difference between (1) the amount realized (i.e., the sale proceeds) and (2) the basis in the stock sold (see Sections 1001(a) and (b)). If property is included in the transaction sale price, then the amount realized by the seller includes the property's FMV (see Section 1001(b)). If the construction company stock is sold at a loss, then the loss will be disallowed if the related-party rules apply.

Claiming an ordinary loss on the sale of Section 1244 stock

Section 1244 allows certain company shareholders to treat losses from the sale of qualified corporation stock as ordinary losses rather than as capital losses. The maximum deductible ordinary loss is $50,000 per year, or $100,000 if the shareholder files a joint tax return. The maximum deductible ordinary loss is further limited to the shareholder's taxable income before considering the amount of the loss.

The $100,000 annual limitation for married taxpayers filing joint tax returns applies whether one or both spouses sustain a Section 1244 loss. Any loss in excess of the annual limitation is considered to be a capital loss.

Because any loss treated as an ordinary loss under Section 1244 (taking into account the annual dollar limitations) is considered a loss from the taxpayer's trade or business, a Section 1244 loss is allowable in calculating the taxpayer's NOL deduction under Section 172. Any resulting NOL can generally be carried back to the two preceding tax years and then carried forward to the next 20 years following the loss year. The NOL deduction created by a Section 1244 loss is allowed in full in the carryback or carryforward year, without regard to the $500,000 or $100,000 annual loss limitation.

Gains and losses on Section 1244 stock are not netted before applying the annual dollar limitation. And, the annual dollar limitation can apply to the sale of Section 1244 stock of the same construction company in different (e.g., succeeding) tax years.

Let's consider a Section 1244 stock sale example. Cal Contractor started a construction company on January 1, 2008, by contributing $1,000,000 in exchange for 1,000 shares of common stock that qualifies as Section 1244 stock. Cal sold 200 common stock shares on February 1, 2013, for $400,000, resulting in a $200,000 gain.

During the second half of 2013, the construction company business begins to deteriorate. Cal sells 600 common stock shares for $100,000 on November 1, 2013, resulting in a loss of $500,000. In the following year, Cal sells the remaining 200 common stock shares for $20,000, resulting in a loss of $180,000.

In this example, in 2013, Cal recognizes a $200,000 long-term capital gain from the February 1, 2013, sale and a $500,000 Section 1244 ordinary loss from the November 1, 2013, sale. In 2014, Cal can claim an additional $180,000 ordinary loss from the sale of the remaining Section 1244 stock.

The construction company cannot have capital receipts in excess of $1 million on the day that the stock is issued in order for the stock to be considered Section 1244 stock. This capital receipts test is applied each time the corporation issues new stock. If new stock shares are issued in exchange for cash or property transferred to the construction com-

SECTION 1244 ALLOWS CERTAIN COMPANY SHAREHOLDERS TO TREAT LOSSES FROM THE SALE OF QUALIFIED CORPORATION STOCK AS ORDINARY LOSSES RATHER THAN AS CAPITAL LOSSES.

pany and the $1 million capital receipts limit is not exceeded, then the new stock will be Section 1244 stock.

Excluding gain from the sale of the qualified small business stock

Section 1202 allows taxpayers (other than corporations) to exclude a certain percentage of the gain from the sale or exchange of qualified small business stock (QSBS) that has been held for more than five years. QSBS is stock originally issued after August 10, 1993, by a C corporation with aggregate gross assets not exceeding $50 million at any time from August 10, 1993, to immediately after the issuance of the stock (see Sections 1202(c) and (d)).

The taxpayer must have acquired the QSBS stock at its original issue or in a tax-free transaction. In addition, the corporation must meet an active business requirement. In that requirement, 80 percent or more of its assets must be used in one or more businesses other than those businesses specifically excluded. Ineligible businesses include certain personal service activities, banking and other financial services, farming, mineral extraction businesses, hotels, and restaurants (see Sections 1202(c)(2) and (e)).

Section 1202(b)(1) limits the amount of the gain eligible for exclusion to the greater of (1) 10 times the taxpayer's aggregate adjusted basis in the stock that is sold or (2) $10 million reduced by any eligible gain taken into account in prior tax years for dispositions of stock issued by the corporation. Any gain in excess of these limitation amounts is taxed under the normal rules for capital gains.

Eligible stock sellers can exclude (1) 50 percent of the gain if the QSBS stock was acquired before February 18, 2009, or after December 31, 2013; (2) 75 percent of the gain if the QSBS stock was acquired after February 17, 2009, and before September 28, 2010; and (3) 100 percent of the gain if the QSBS was acquired after September 27, 2010, and before January 1, 2014.

Given the satisfaction of the five-year ownership requirement, QSBS stock sold during 2013 will be eligible for the 50 percent of gain exclusion. For 2014 sales, any stock purchased before February 18, 2009, will qualify for the 50 percent of gain exclusion, while any stock purchased after February 27, 2009, will qualify for the 75 percent of gain exclusion.

Conclusion

The owners of a closely held construction company have to decide if and when they want to sell the company. Once they decide to sell the construction company, the owners also have to decide on the preferred sale structure. In particular, the owners have to decide if they want to sell the construction company assets or the construction company stock.

In addition to numerous legal considerations, there are direct tax consequences associated with the decision to sell company assets compared to company stock. This discussion summarized some of the tax considerations related to structuring the sale of the closely held construction company. ■