SIMULTANEOUS SALE AND REDEMPTION

By: Stuart M. Bordman

I. FACTS

A. Seller is a Michigan corporation organized in 1985. The Seller has one shareholder ("Shareholder") who owns all 1000 shares of the corporation's outstanding stock. Seller provides services in the healthcare industry but is not a professional corporation. Seller is an "S" corporation and utilizes cash basis for income tax purposes. Seller's assets consist of cash, equipment with the net book value of $50,000; accounts receivable ("A/R") of $1 million and a lawsuit with the potential collection after costs and legal fees of $200,000. Seller has no debt other than ordinary trade payables.

B. Seller leases its space from an unrelated landlord. Shareholder has **not** personally guaranteed the lease or any other obligations of the corporation.

C. Seller desires to sell its business and has found a purchaser for the business who is willing to pay $1,200,000 for the assets of the business exclusive of cash, A/R and the proceeds of the lawsuit.

II. ISSUE

The purchaser does not want to purchase the stock of the corporation, but for business purposes the purchaser needs to utilize the corporation's employer identification number.

III. SOLUTION

A. Purchaser, Seller and Shareholder enter into a simultaneous sale and redemption agreement.

B. Shareholder sells 500 shares of his stock to the purchaser for $1,200,000.

C. The seller redeems 500 shares of the shareholder's stock in exchange for cash in bank, A/R and the proceeds of the lawsuit.

D. As a result of the sale and redemption, the purchaser will own all of the outstanding stock of the corporation.

IV. TAX CONSEQUENCES

A. Shareholder receives capital gain treatment on the sale of his shares to the purchaser equal to the difference between his basis in the shares and the $1,200,000 sale price.

B. IRC Section 311 provides that no gain will be recognized to a corporation upon distribution of its property. However, Section 311 (b) provides that if the corporation distributes property to a shareholder and the fair market value of the property exceeds the adjusted basis of the property in the hands of the distributing corporation gain will be recognized by the distributing corporation as if the property were sold to the distributee at its fair market value.

C. The seller has a zero basis in its A/R and in the lawsuit and accordingly the seller will recognize gain on distribution of those assets to shareholder. Because the corporation is an "S" that gain will pass through to the shareholder and will increase his basis in the stock of the corporation.

D. The purchaser, the seller and shareholder will elect to have the tax year of the "S" corporation divided into two years for income tax purposes with the first year ending on the date of sale and the second year ending on December 31. All of the income for the first year will be reported by shareholder on his 1040 and all of the income for the second year by the purchaser on his 1040.

E. The corporation (now owned by the purchaser) continues to use the employer identification number.

F. The corporation will continue to depreciate equipment without any step up in basis. The purchaser cannot amortize any covenant not to compete or other intangibles pursuant to Section 197 of the Internal Revenue Code. Had the sale been an asset sale, the purchaser would have received a step up in basis for the equipment and amortization of intangibles.

V. NONTAX ISSUES

A. There is no assignment of the office lease since the corporation is the tenant. However, the lease contained a change in control provision and the consent of the landlord was required. Other agreements with third parties may also require consent if there is a change in control provision.

B. If the shareholder has personally guaranteed any obligations of the corporation the guaranty continues even after sale and redemption. Accordingly, any such personally guaranteed obligations should be terminated in connection with the closing, if possible. If not, the purchaser must indemnify, defend and hold the shareholder harmless with respect to any such obligations.

C. The purchaser is in control of the business and a mechanism must be developed so the shareholder can monitor collection of the A/R and receive cash as collected.

D. Signatory authority over the bank account must be changed or a new bank account opened for post-closing transactions. A/R must be deposited into the corporation's bank account, but the cash must distributed to the Shareholder as collected.

E. The A/R and the lawsuit must be valued. The value of A/R is equal to cash collected and the shareholder can wait until shortly before his 1040 is due to value the A/R. What if cash comes in after the tax return is filed? What if the amount collected with respect to the lawsuit is less than the value placed on the lawsuit? Better to value low and treat any excess as miscellaneous income.

F. How do you address lawsuits for actions which took place before sale and redemption? Even risks covered by insurance may have a deductible.