PRACTICE NOTE: AVOIDING A TAX-FREE TRANSACTION: WHEN TAXABLE IS TAX-EFFICIENT

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I. INTRODUCTION

The conventional wisdom is that it does not make sense to trigger the recognition of taxable income in order to secure the benefit of future deductions. Thus, when restructuring the ownership of appreciated assets, parties may go to great lengths to ensure that their transactions qualify for nonrecognition of gain. Reducing or eliminating the tax on the restructuring generally is considered of greater importance than any benefit to be obtained from a step-up in basis of assets achieved through a taxable transaction. Notwithstanding this conventional wisdom, in light of the current divergence between the tax cost of recognizing capital gains and the tax benefits from depreciation or cost recovery deductions, it should be understood that sometimes the tax benefits to be obtained from a step-up outweigh the cost of a taxable transaction. Thus, as set forth

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below, one should not lose sight of the relative costs and benefits of a *taxable* transaction.

II. TYPES OF TRANSACTIONS TO CONSIDER

A. *Organizing a Business Entity*

As a general rule, a taxpayer may contribute appreciated assets to a newly-formed corporation or partnership (including an LLC treated as a partnership for federal tax purposes) solely in exchange for an equity interest therein without recognizing any taxable gain.[1] If the contributor receives money or other property (including debt of the corporation or partnership) in addition to equity of the corporation or partnership, the contributor will recognize gain to the extent of the lesser of (i) the appreciation in the contributed assets and (ii) the fair market value of the money or other property ("boot") received.[2] The corporation's or partnership's tax bases in the contributed assets will be the same as the contributor had in such assets—increased ("stepped-up") to reflect the amount of any gain recognized.[3]

B. *Disposing of a Business*

The foregoing rules governing contributions of assets to a corporation or partnership also have application to the disposition of an entire business to a new or existing corporation or partnership in exchange for equity of the corporation or partnership. In the context of a disposition to a corporation (i.e., a corporate acquisition), so long as the party transferring assets to the corporation (when considered together with any other persons transferring or contributing assets to the corporation at the same time) owns at least 80 percent of the corporation after the transfer, the transferor may qualify for nonrecognition of gain.[4] Thus, a so-called "roll-up" of small businesses into one

1. *See* I.R.C. § 351 (2000) (corporation); *id.* § 721 (partnership). An exception applies for certain debt-like preferred stock of a corporation ("nonqualified preferred stock") the receipt of which will be treated in the same manner as the receipt of debt issued by the corporation as described in the text below. *See id.* § 351(g). Unless otherwise indicated, all references to "section" or "§" are to the Internal Revenue Code of 1986, as amended (the "Code").

2. *Id.* § 351(b) (corporation); *id.* § 721(b) (partnership).

3. *See* I.R.C. § 362 (corporation); *id.* § 723 (partnership).

4. *See id.* § 351 (requiring a transferor of property to a corporation, either alone or together with other transferors to "control" the corporation immediately after the transfer in order to qualify for nonrecognition); *id.* § 368(c) (defining "control" as the ownership of at least 80 percent of the total combined voting power of voting stock and at least 80 percent of each class of nonvoting stock of the corporation).

corporation may qualify for nonrecognition of gain, even though the owners of each business will own only a small minority of the corporation formed in the roll-up.[5] An acquisition of assets by a partnership in exchange for partnership equity, by contrast, may qualify for nonrecognition of gain regardless of the extent of the contributor's ownership of the partnership following the contribution.[6]

III. CHARACTER OF GAIN RECOGNIZED

The character of the gain recognized in a taxable disposition of assets, including gain recognized in the types of contributions and business combinations just described, generally will depend upon the character of the assets being disposed. Gain recognized on the disposition of accounts receivable or inventory will be ordinary income subject to federal income tax at rates up to 35%.[7] Gain recognized on the disposition of other assets, to the extent such gain exceeds the amount of any prior depreciation deductions required to be "recaptured" as ordinary income upon a taxable disposition of such assets, generally will be capital gain and may be subject to a maximum rate of federal income tax of 15% if the person disposing of such assets is an individual and held the assets for more than one year.[8] Notwithstanding the

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5. *See* BORIS I. BITTKER & JAMES S. EUSTICE, *Federal Income Taxation of Corporations and Stockholders*, 3.08[1] (7th ed. 2000 & Supp. 2004); *see also* I.R.C. § 351. A tax-free reorganization under section 368 stands in contrast to a roll-up or other transaction structured to qualify for nonrecognition of gain under section 351. *Compare* I.R.C. § 368, *with* § 351. In a tax-free reorganization, the acquiring corporation generally takes a carryover basis in the acquired assets. *See* BITTKER & EUSTICE, *supra*, at 12.01[2]. That is, the acquiring corporation does not obtain a step-up in basis of the acquired assets, even when the consideration for the acquisition includes "boot" and the shareholders of the target corporation recognize taxable gain. *See* I.R.C. § 361(b)(1), (3) (stating the target corporation itself recognizes no gain in a reorganization provided it distributes to its shareholders any boot received from the acquiring corporation); *id.* § 362(b) (providing the acquiring corporation's basis in acquired assets is increased only to the extent of gain recognized by the target corporation).

6. *See* I.R.C. § 721.

7. *See id.* § 1(i)(2) (2000 & Supp. 2004). Throughout this discussion, tax consequences are described in terms of maximum nominal rates of federal income taxes. When considering the actual tax consequences to a given taxpayer, consideration must be given to the effects of graduated rates, alternative minimum taxes, miscellaneous itemized deductions, and other limitations and restrictions – as well as state and local taxes – all of which may cause a taxpayer's effective rate of taxation to differ from the stated rates. *See, e.g., id.* § 1 (computation of individual taxable income); *id.* § 55 (alternative minimum tax); *id.* § 68 (itemized deductions).

8. *See* I.R.C. § 1(h)(1)(c) (taxation of capital gains); *id.* § 1221 (defining "capital assets"). Provided the assets or property have been held for more than one year, gains recognized on either (a) a sale of assets subject to the allowance for depreciation, or (b) real property used in a business are generally treated as "section 1231 gains." *Cf. id.* § 1231(c)(1) (recapture of prior year ordinary losses under section 1231), and § 1245

preceding general rule, with respect to the disposition of assets that would be depreciable in the hands of a corporate or partnership acquirer, if the person transferring such assets to the corporation or partnership (and/or certain persons related to such transferor) owns more than 50 percent of the acquirer, then any gain recognized will be ordinary income and will be subject to federal income tax at rates up to 35%.[9]

IV. GAIN EQUALS STEP-UP, STEP-UP EQUALS TAX BENEFITS

As previously described, a taxpayer that receives boot (or nonqualifying consideration) in exchange for appreciated assets will recognize gain.[10] The recognition of this gain, however, will give rise to tax benefits to the acquirer in the form of a step-up in the tax bases of the assets acquired.[11] The acquirer may use this step-up to offset gain on a future disposition of the assets or, in the event such assets are subject to the federal income tax allowance for depreciation or amortization, the acquirer may effectively "write off" (or take deductions equal to) this step up over a period of years beginning with the year of the acquisition.[12] These depreciation or amortization deductions thus may reduce the acquirer's (and, in the case of a partnership, its owners') future net income subject to tax.[13]

(recapture of prior depreciation deductions). A taxpayer is required to aggregate its section 1231 gains and losses each year. *See id.* § 1231(c)(1). If the aggregate represents a gain, such gain is characterized as a long-term capital gain. *See id.* § 1231(a)(1).

9. *See* I.R.C. §§ 707(b)(2), 1239.

10. *Supra* Part II.A.

11. *See* I.R.C. § 167(a).

12. *See id.* §§ 167, 168, 197. Various "anti-churning" rules exist that attempt to restrict a taxpayer's ability to take advantage of changes in depreciation rules, which permit more accelerated depreciation or amortization of assets. *See, e.g., id.* §§ 168(f)(5), 197(f)(9). Due to the limited changes to depreciation rules since 1993, these anti-churning rules may have limited application to new businesses formed after 1993. *See id.* §§ 68(f)(5), 197(f)(9). Nonetheless, they must be considered in any case.

13. It should be noted that in the context of a tax-free contribution of assets to a partnership, section 704(c) of the Code generally seeks to place the non-contributing partners in the same position they would have been in if the partnership had purchased the contributed assets. *See* I.R.C. § 704(c). Nonetheless, the effect on a contributor of depreciable property subject to section 704(c) may be quite different than a taxable sale or disposition of such property to the partnership. *See* WILLIAM S. MCKEE ET AL., FEDERAL TAXATION OF PARTNERSHIPS & PARTNERS ¶ 10.04 (3d ed. 1996 & Supp. 2004). In a sale, the contributor may recognize long-term capital gain (taxable at a maximum rate of 15% for individuals) and then share in depreciation deductions (which may reduce its income subject to tax at a maximum rate of 35%). *See id.* In a contribution subject to section 704(c), the contributor recognizes no gain upon contribution, but then may effectively recognize a share of such gain as ordinary income to the extent necessary to provide depreciation deductions to the non-contributing partners. *See id.* The effect generally is not as favorable to an individual contributor who may benefit from a reduced rate of tax on capital gains. *See id.*

Because the amount of the step-up is exactly equal to the amount of the gain recognized, if the rate of tax imposed on the gain recognized by the transferor were the same as the rate of tax used to determine the acquirer's future tax benefits, the conventional wisdom would be correct: It would make no sense to trade the current recognition of taxable gain for a future tax benefit of the same amount. The present value of the future benefit undoubtedly would be less than the present cost. As described above, however, the rate of tax imposed on the gain recognized by a transferor of appreciated assets is not necessarily the same as the rate used to determine the tax benefits that accrue to the acquirer. As indicated above, the transferor's gain may qualify as long-term capital gain subject to tax at a maximum rate of 15%, while the acquirer may deduct the amount of the step-up against ordinary income subject to tax at a maximum rate of 35%. Thus, in an appropriate case, the combination of the low rate of federal income tax imposed on long-term capital gains recognized by individuals and the significantly higher rate of tax imposed on ordinary income against which the acquirer's depreciation deductions may be taken may cause a taxable transaction to be more attractive than a tax-free transaction.

V. EXAMPLE

For example, assume that a group of individuals (the "Individuals") form a partnership to conduct domestic business operations. Several years later, they agree to the acquisition of their partnership on "Day 1" of "Year 1" by a corporation ("Acquiring Corp."). For simplicity, assume that the partnership's sole assets are goodwill and a customer list, in which the partnership has no tax basis and the sale of which would generate long-term capital gain. Further assume that Acquiring Corp. is subject to federal income tax at a 35% rate on all of its income.

A. *Alternative 1: Taxable Acquisition*

Assume that Acquiring Corp. pays the Individuals $10 million in cash in exchange for their partnership interests. As a result, Acquiring Corp. would have an aggregate $10 million basis in the assets acquired.[14] The acquired assets (goodwill and a customer list) generally would be amortizable section 197

14. I.R.C. § 1012 (2000) (defining basis).

intangibles in the hands of Acquiring Corp.[15] Thus, Acquiring Corp.'s basis in such assets generally would be amortized by it on a straight-line basis over 15 years.[16] As a result, Acquiring Corp. would save an amount in federal income taxes each year (generally, beginning with its estimated tax payments due for the first quarter of Year 1) equal to 35% multiplied by the amount of the previously described amortization deductions. The value of these deductions, as illustrated in the following table, may well exceed the costs incurred by the Individuals.

Tax Cost or (Benefit) by Year		
	Individuals	**Acquiring Corp.**
Year 1	Individuals' long-term capital gain (assumed equal to $10 mm), multiplied by maximum 15% long-term capital gain tax rate, or **$1.5 mm**[17]	1/15 of Acquiring Corp.'s adjusted tax basis in the acquired assets (assumed equal to $10 mm), multiplied by maximum 35% corporate income tax rate, or **($233k)**[18]
Year 2	**$0**	**($233k)**
. . .	**$0**	**($233k)**

15. *See id.* § 197(a), (c)(1). The related party ordinary income-capital gain recharacterization rule of section 1239, and the anti-churning rule of section 197(f)(9), should be considered in the event the Individuals have a direct, indirect or constructive interest in Acquiring Corp.

16. *See* Treas. Reg. § 1.197-2(f)(1)(i)(A) (2004) (amortization period generally begins with the first day of the month of the acquisition).

17. For simplicity, in determining the Net Present Value described below, it is assumed that one-fourth of this amount is payable on each of April 15, June 15 and September 15 of Year 1 and January 15 of Year 2 (the due dates for an individual's estimated tax payments). It should be noted that the tax results to the Individuals may be improved in the event the Individuals receive Acquiring Corp. indebtedness in exchange for their partnership interests. Subject to section 453A (interest charge for deferral of tax on installment obligations in excess of $5 million), the Individuals may be entitled to take into account their gain over the term of the indebtedness. *See* I.R.C. §§ 53; *cf. id.* § 453(g) (section 453(a) does not apply to a sale of depreciable property between related persons, and the purchaser obtains a step-up in basis of assets acquired in such an installment sale only as and to the extent the seller takes into account its gain).

18. For simplicity, in determining the Net Present Value described below, it is assumed that the benefit of one-fourth of this amount is obtained on each of April 15, June 15 and September 15 of Year 1 and December 15 of Year 2 (the due dates for a calendar year corporation's estimated tax payments). *See* IRS Form 1120-W, at 5 (line 24 general instructions) (2004).

Year 15	**$0**	**($233k)**
Total Tax Cost or (Benefit)	**$1.5 mm**	**($3.5 mm)**
Net Present Value of Tax Cost or (Benefit), Assuming 7%[19] Discount Rate	**$1.44 mm**	**($2.15 mm)**

B. *Alternative 2: Tax-free Acquisition*

Assume instead that the acquisition described above occurs at the same time as other acquisitions by Acquiring Corp. As a result, assume that even though the partnership's assets would represent only a relatively small part of the value of Acquiring Corp.'s assets, the acquisition could be structured to qualify for nonrecognition of gain under section 351 in the event the Individuals received Acquiring Corp. stock in exchange for their partnership interests.[20] If the Individuals received solely Acquiring Corp. stock, and held such stock until death (at which time their estates would receive a step-up in basis in such stock under section 1014), the Individuals would effectively incur no federal income tax cost on the disposition of their partnership interests.[21] Acquiring Corp., however, would achieve no step-up in tax bases of the partnership's assets and thus would be expected to pay a reduced amount for such assets relative to the amount it would have paid with a step-up. (Of course, a countervailing consideration is that the Individuals may demand additional consideration to reflect the subordinate claim against the assets of Acquiring Corp. represented by the Acquiring Corp. stock.)

VI. CONCLUSION

While there obviously are differing considerations to be taken into account in planning any given transaction, it is useful

19. The appropriate discount rate is obviously subject to debate. In setting the rate to be used, and in otherwise considering the potential benefits to Acquiring Corp., consideration should be given to the likelihood that Acquiring Corp. may be able fully to utilize the amortization deductions at issue.

20. *See* I.R.C. § 351 (a).

21. *See* I.R.C. § 1014 (a) (explaining basis transferred upon death).

to keep in mind that the tax benefits derived from a step-up in basis achieved through a taxable acquisition sometimes exceed the tax cost to a taxpayer disposing of assets. Thus, when the sellers are individuals whose gain would be subject to tax at long-term capital gains rates, trading a current tax cost for a future tax benefit may be beneficial. Of course, the costs and benefits of the transaction are imposed on different parties, and thus it will be important to determine whether and to what extent the acquirer is willing to compensate the seller for the tax (i.e., how much of the additional benefits the acquirer is willing to share with the seller). Furthermore, the tax benefits at issue will be recognized by the acquirer over a period of years. Intervening events, such as the recognition of unrelated operating losses, may potentially defer or eliminate the benefits to the acquirer and thus should be carefully considered before purposefully engaging in a taxable transaction. Nonetheless, somewhat surprisingly, a taxable transaction should not always be assumed to be tax-inefficient. In other words, sometimes taxable is tax-efficient.