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HERTEN BURSTEIN

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Counsellors at Law

INSIGHTS and Developments in the Law

Buying or Selling a Business Series: Tax Issues on Stock or Asset Purchase

By Gianfranco A. Pietrafesa

In our last newsletter, we examined the significant differences in the legal consequences between an asset deal and a stock deal. This article will explain the different tax consequences between the deal structures.

Tax on Gains

In an asset deal, the selling corporation sells its assets to the buyer and pays taxes on any gains, basically the difference between the cash received from the sale of assets and its tax bases in the assets. When the corporation distributes the cash from the sale of assets to its shareholders, the shareholders will have to pay taxes on the distribution. Thus, there is double taxation, which reduces the amount of money received by the shareholders.

In a stock deal, the selling shareholders pay taxes on any gains, which is the difference between the cash received from the sale and their tax bases in the shares. There is no tax paid by the corporation since it is not selling anything.

Tax Basis in Assets

In a stock deal, the buyer acquires the corporation and "inherits" the corporation's tax basis in its assets. For example, if the buyer pays $500,000 to the shareholders for their stock, and the corporation owns assets with a tax basis of $300,000, the corporation's tax basis in the assets will remain $300,000 after the deal closes. In an asset deal, the buyer gets a stepped-up basis in the assets equal to the fair market value ("FMV") of the assets. Therefore, if the assets have a FMV of $500,000, the buyer's tax basis in the assets will be $500,000.

The difference in tax basis is important when the buyer later sells the assets. In a stock purchase, the corporation retains ownership of the assets. If the corporation later sells the assets for $600,000, the corporation will have to pay taxes on a gain of $300,000 ($600,000 less its original tax basis of $300,000). In an asset purchase, the buyer acquires the assets and if it later sells the assets for $600,000, it will have to pay taxes on a gain of only $100,000 ($600,000 less the buyer's stepped-up tax basis in the assets of $500,000). In certain circumstances, a buyer may be able to make an election under Section 338 of the Internal Revenue Code to treat a stock purchase as an asset purchase for tax purposes.

Conclusion

Obviously, there are significant and different tax consequences between an asset deal and a stock deal, which may affect the purchase price. A prudent client will want to discuss the structure of a deal with its legal counsel and tax advisor before engaging in discussions with the other party.

For more information on stock or asset purchases, please contact Gianfranco Pietrafesa at gpietrafesa@hertenburstein.com. ▲

Life Insurance Trusts – An Old Standby

By Andrew J. Cevasco

When life is uncertain, we have a tendency to stick with what is tried and true. Estate tax couldn't be more uncertain at the moment, and getting back to the basics has a lot of appeal. Use of an irrevocable life insurance trust remains one of the most effective weapons in the estate planning arsenal.

First, there are good non-tax reasons for a life insurance trust. Most people purchase significant life insurance because of family

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Why Creditors Should Consider the Virtues of Selling Goods on Consignment Under the Bankruptcy Law

By Anthony E. Hope and Daniel Y. Gielchinsky

As a result of the economic downturn, lenders and vendors are increasingly finding themselves becoming parties to bankruptcy proceedings involving a corporate liquidation or reorganization in the bankruptcy courts. The retail clothing and jewelry industries have been particularly hard hit over the last year, and we have seen various significant bankruptcies in these areas.

One instance is in *Whitehall Jewelers, Inc.,* where the debtor and a group of consignment vendors engaged in motion practice concerning the status of consignment goods sold by the vendors to the debtor pursuant to consignment agreements and UCC filings. The debtor claimed that it had the ability to sell consignment goods over the objections of the vendors/creditors. The resulting decision by the Court denying the debtor's motion to sell the consignment goods free and clear of liens in the case highlights the benefits vendors should receive when selling goods pursuant to properly documented consignment arrangements and UCC financing statements.

A typical consignment arrangement consists of a consignee acting as an agent of the consignor for the purpose of delivering the goods to third-party customers. The consignee collects the sales proceeds of the goods for the benefit of the consignor, and keeps a portion of the sale as its profit. In such an arrangement, there is no absolute obligation on the part of the consignee to pay for the goods because the consignee is not the buyer. Title to the goods remains with the consignor. Consignment agreements frequently provide that a consignor owns a security interest in the goods as well as in the proceeds derived from any sale.

Providing goods on consignment has several benefits. The validity of consignment agreements and the security interests created by UCC financing statements must be the subject of a court proceeding if a debtor or other party-in-interest attempts to challenge the consignment's effectiveness. Second, the consignment agreement offers the consignor an opportunity to set a price floor, offering protection against debtors selling consignment goods at low prices during a liquidation sale. Third, the consignment goods remaining unsold at the time of a debtor's bankruptcy filing can be reclaimed by filing a notice and seeking relief pursuant to 11 U.S.C. Section 546. In the event a debtor sells consigned goods pre-petition but does not turn over the sales proceeds to the consignment vendor, the consignor may be entitled to a priority claim as an administrative expense. These benefits may be available provided that the consignment arrangement comports with the requirements of the UCC.

The drafting of a consignment agreement and financing statement requires skill and due care. Not only must the documents clearly delineate the scope of the parties' agreement and the security interests envisioned, but a price floor should also be included. The same applies to the financing statement, which requires a detailed description of the security interest that is intended to be created. State-specific concerns relating to security interests should also be addressed, since some states have adopted modified versions of the model Uniform Commercial Code. Only when these criteria and the requirements set forth by Article 9 of the UCC are followed will a creditor enjoy the protections of a consignment arrangement contemplated when the consignee files for bankruptcy.

For more information on bankruptcy law, please contact Anthony Hope at ahope@hertenburstein.com or Daniel Gielchinsky at dgielchinsky@hertenburstein.com. ▲

News from Herten Burstein

Commercial Lending Member **Nilufer DeScherer** was one of the presenters at a continuing legal education seminar entitled "Negotiating Real Estate Loan Terms and Work Out Options," presented by the National Business Institute.

Business Law Member **Gianfranco Pietrafesa** made two presentations to the Hudson-Bergen Inn of Transactional Counsel: on "Contract Boilerplate Provisions - Small Print, But Big Issues" and "Legal Ethics for Negotiators." Franco is a trustee of the Hudson-Bergen Inn of Transactional Counsel, which advances the education of attorneys in transactional law and practice, professionalism and ethics.

Associate **Anthony Hope** and Member **Daniel Gielchinsky** published an article in the New Jersey Law Journal's annual Bankruptcy Law supplement, entitled "Creditors Should Consider the Virtues of Selling Goods on Consignment." The article provided a comprehensive overview of the benefits of consignment sales arrangements as a device to protect wholesalers, manufacturers and vendors against various bankruptcy risks.

Litigation Member **Terry Paul Bottinelli** was selected to join the Hall of Fame of Bergen Catholic High School. Terry was also a judge at the National Collegiate Mock Trial competition at Yale University.

Cynthia Brooks, Of Counsel in the Commercial Real Estate practice, was elected to serve as the Chair of the Board of Trustees for Calvary Baptist Church, located in Morristown, NJ. The church has approximately 1,500 members and is in the midst of a $26 million capital campaign.

Member **RJ Contant** was honored by Martindale-Hubbell for celebrating 25 years of being an AV-rated attorney. He is one of 12 Herten Burstein attorneys with an AV rating from Martindale-Hubbell.

Herten Burstein was a sponsor of "The Event," an annual get-together for the business and professional sectors hosted by the UJA Federation of Northern New Jersey's Commerce and Professionals Section, of which Herten Burstein's **Jason Shafron** is a co-chair. ▲

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needs – young children or a spouse who will need a source of support if the primary breadwinner dies prematurely. In those circumstances, it is usually a good idea to use a trust to hold the life insurance proceeds to protect the beneficiaries from either their own naiveté or the risk of financial predators. Appointing a trusted advisor, friend or family member to invest wisely and pay out the proceeds for health, support, maintenance and education of the beneficiaries is the best way to be sure that the insurance will serve its purpose. You can also use the trust to encourage appropriate behavior by tying distribution to education goals or providing income to allow a child to pursue charitable work or stay home to raise the grandchildren.

From a tax point of view, the irrevocable life insurance trust is a great benefit. Insurance proceeds are includable for federal and New Jersey estate tax if the policy is owned by the decedent. However, if the policy is owned by the trust, the proceeds are exempt from estate tax. Since, under the current law (there is no telling how long before Congress gets around to looking at it or what they will do with it once they do), the federal estate tax exemption will be limited to $1 million in 2011 and the tax rate will top out at 55%, keeping life insurance proceeds out of the estate will double the amount of money available to a family with a taxable estate. Although the tax rate is less than the federal rate, with an exemption at a mere $675,000, the New Jersey estate tax provides its own incentive for a life insurance trust.

Incorporating a life insurance trust into your estate plan requires a comprehensive assessment of your estate and your life circumstances with a competent professional. Its advantages can be significant. We at Herten Burstein would be glad to help you determine whether it makes sense for you.

Actual resolution of legal issues depends upon many factors, including variations of facts and state laws. This newsletter is not intended to provide legal advice on specific subjects, but rather to provide insight into legal developments and issues. The reader should always consult with legal counsel before taking action on matters covered by this newsletter.

Credit CARD Act

Recently, the Credit Card Accountability, Responsibility, and Disclosure Act of 2009 (the Credit CARD Act) went into effect. Congress saw a pressing need to protect consumers from abusive fees, penalties, interest rate increases and other unjustified changes in the terms of credit card accounts. A new hike in the penalties for violators of the Act will provide extra incentive for compliance.

A few of the highlights of the Act are:

- The Act prohibits rate increases on existing balances due to "any time, any reason" or "universal default," and severely restricts retroactive rate increases due to late payments.

- Contract terms must be clearly spelled out and must remain in place for all of the first year. Companies may continue to offer promotional rates with new accounts or during the life of an account, but these rates must be clearly disclosed and must last at least six months.

- Institutions are required to give credit card holders a reasonable time to pay the monthly bill—at least 21 calendar days (up from 14) from the time of mailing.

- Credit card companies are required to apply excess payments first to the highest interest balance (usually for new purchases), as most consumers would expect them to do, but which some companies have not done because it is not as profitable.

- The Act ends the confusing practice by which issuers use the balance in a previous month, even if all or a part of it was paid off, to calculate interest charges on the current month. Many consumers likely were not even aware of this particular practice, called "double-cycle" billing.

- Credit card holders will find it easier to avoid over-limit fees because institutions now have to obtain a consumer's permission to process transactions that would place the account over the limit. So that consumers can better avoid unnecessary costs and manage their finances, creditors must give consumers clear disclosures of account terms before consumers open an account and clear statements of the activity on consumers' accounts afterwards.

The Act contains new protections for college students and young adults, formerly a favorite target for blanket marketing of credit cards. Among other things, there is a new requirement that no card be issued to anyone under 21 unless he or she submits a written application, with either the signature of a co-signor over 21 or information showing independent means for repaying the credit card debt. ▲

E-Mailed Documents Allowed

Shortly before he left the employment of a residential treatment center for addicted persons, an employee e-mailed some of his employer's documents to his and his wife's personal e-mail accounts. The employee operated two consulting businesses of his own concerning addiction rehabilitation services. The employer's documents, including its financial statement and the names of past and current patients at the center, could have been useful to those businesses.

When the employer discovered that the documents had been e-mailed, it sued the then-former employee under the federal Computer Fraud and Abuse Act (CFAA). The CFAA provides civil (and criminal) remedies for knowingly accessing a protected computer without authorization or for exceeding authorized access. A federal appellate court ruled in favor of the employee.

The language in the CFAA prohibiting the accessing of a computer without authorization means that the person has not received permission to use the computer for any purpose (such as when a hacker accesses a computer without permission), or when a computer owner, such as the employer, has rescinded permission and the defendant uses the computer anyway. Neither scenario describes what happened in the case before the court.

The employee, so long as he remained employed, had permission to access and use the company's computers. There was no written employment agreement or set of guidelines for employees that might have prohibited or restricted employees of the company from e-mailing the company's documents to personal computers. If keeping in-house documents in-house was a priority for the company, it would have been wise to incorporate appropriate restrictions on computer access and use by employees into an agreement or personnel policy. ▲