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Doron F. Eghbali Buying and Selling of Businesses

Fundamentals of Contract for Sale of Business

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Like any other business transaction, sale of a business encompasses myriad of considerations. Such considerations often involve risk and its allocations to the parties involved. Parties often have to negotiate and agree upon the price, the allocation of sale price to various assets included in the sale price, and tax ramifications of such asset allocation, among others. Hence, it is incumbent upon seller and purchaser of a business to carefully and prudently evaluate such business transaction to eschew or mitigate potential and actual risks and pitfalls, to the extent possible. This article seeks to provide a panoramic perspective on such salient topic by exploring some of the most salient risks without a detailed analysis of corresponding risks.

1. DESCRIPTION OF PROPERTY OR LACK THEREOF

The Sale Contract should encompass and enumerate all the properties or assets as part of the sale price being transferred and those NOT being transferred.

Transfer of leasehold interest should be accomplished through a proper written assignment considering the main leasehold agreement with landlord. It is possible that the landlord not allow the assignment of the lease to the purchaser, in that case, it might be critical for purchaser to take steps to indemnify the seller.

In addition, the Sale Contract should not only enumerate the assets being sold and transferred as part of the sale, but also enumerate the condition of each asset to further eschew problems down the road.

2. THE AMOUNT OF PURCHASE PRICE

The methodology employed to ascertain the purchase price for the business and each individual asset is the sphere of a financial expert and not an attorney. Nonetheless, the due diligence undertaken to examine the books and records for the amount of purchase price should be used to identify the risks and liabilities to be incorporated in the Sale Contract.

3. ALLOCATION OF PURCHASE PRICE IN THE SALE CONTRACT

It is incumbent upon parties to properly and accurately allocate the agreed upon purchase price among various assets being sold for tax purposes. This asset allocation helps purchaser of the business to ascertain the proper basis in the assets being acquired and for the seller of business to determine if there are any applicable losses or gains on the assets being sold.

There are some restrictions on the allocation of the purchase price from tax perspective. Parties are not allowed to allocate purchase price based on their own preferences, but they are required to employ "residual method of accounting". Such method of accounting classifies assets in per-designated categories and then the purchase are computed based on such categories or classes. Purchase price should be allocated to classes or categories in the highest class and then sequentially, as one class is done, the other class should be dealt with.

Such residual method of accounting applies to any asset acquisition in which direct or indirect asset transfer involves:

1. Assets constituting "trade" or "business"; AND
2. Assets' basis for the purchaser is entirely ascertained by the buyer's consideration for the assets.

Therefore, under the "residual method of accounting", the asset purchase price is allocated and reduced in the following order:

1. **"CLASS I ASSETS":** Class I assets consists of cash, demand deposits and similar accounts in bank, savings and loans associations and other items designated by IRS in its bulletin.
2. **"CLASS II ASSETS":** Class II assets are certificates of stock, US government securities, readily available stock or securities, foreign currency and other items designated by the IRS applicable bulletin.
3. **"CLASS III ASSETS:** Class III assets encompass all the other assets not specified in this list, to some extent.
4. **"CLASS IV ASSETS":** Class IV assets encompass all the intangibles with the exception of the intangibles in the nature of goodwill and going concern value.
5. **"CLASS V ASSETS":** Class V assets encompass all the intangibles in the nature of goodwill and going concern value.

SALIENT NOTE

It is extremely important to note the parties are bound to the written agreements as to the fair market value of purchased assets including goodwill and going concern value, unless the IRS determines such fair market value and asset allocation are improper.

4. ASSUMPTION OF LIABILITIES

Purchasing a business, often, also encompasses assuming liabilities the business has accumulated, unless the agreement states otherwise. In fact, in CA, a voluntary acceptance of the benefit of a transaction also carries all the liabilities known or should have known to the buyer at the time of entering into the transaction. This latter rationale is partly predicated on the fact if the buyer is aware or should have been aware of all the liabilities of the business as it appears on the books, then the buyer would have been able to negotiate a price reflecting such liabilities.

5. CLOSING OF SALE

It is imperative the contract articulate the DATE and PLACE of closing, i.e. when the title transfers from seller to buyer. Usually, signing the contract and transferring the title are concurrent. Nonetheless, it is possible the parties sign the contracts, but, intend for the title to be transferred at a later date. Accordingly, it is imperative the contract enumerates and articulates the rights and obligations of the parties if the execution (signing) and closing (transfer of title) are to occur at different dates.

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