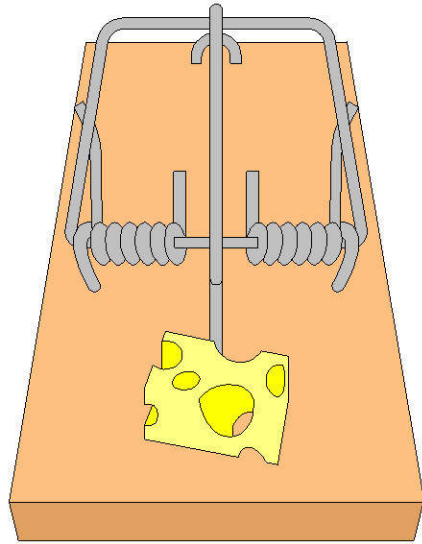


# The Story of A. Better

## Mousetrap, Inc.<sup>1</sup>



---

<sup>1</sup> Originally this was supposed to be “Tax Aspects to Buying and Selling a Business” but hey, who thought of such a boring name for a scintillating presentation such as this!



**Christopher M. Barclay**

**Husch & Eppenberger, LLC<sup>2</sup>**

---

<sup>2</sup> Special thanks to Deke Karzon for reviewing my tax calculations to determine whether they were correct and my simplistic explanations of parts of the tax code to determine whether they were correct.

The story of A. Better Mousetrap, Inc. begins at the end of World War II (a/k/a the “Big One”) when Anthony Better returned from fighting bad guys in Europe and settled in with his wife of three years on the “Hill” in St. Louis. Anthony worked hard as a baker at the Missouri Baking Company for several years. Over time he and his lovely wife had three boys: Ed, Steve and Rich.<sup>3</sup> Anyway, during his long shifts in the Bakery Anthony couldn’t help but notice that mice continually got into the Bakery notwithstanding the use of conventional mousetraps. One day, Anthony designed a contraption that caught 50 % more mice than conventional mousetraps. Encouraged by the Bakery owners, Anthony set up his own company, A. Better Mousetrap, Inc.

Business was good. The Better Mousetrap™ was a hit! At first, all three boys worked in the family business. However, after a few years Ed left and went into the banking business. Rich, got into some trouble and Anthony sent him away to Italy for a few years to learn the “old way”. Steve stayed with the company and by the mid 80’s became Vice President of A. Better Mousetrap, Inc.

Unfortunately, disaster hit. Anthony met an untimely death<sup>4</sup> do to a rare heart condition (and some say a young woman, but that is another story). Anthony was followed in death by his wife who died of a broken heart (or aneurysm if you believe the story about the young woman). At any rate, A. Better Mousetrap, Inc. was left to the three boys in equal shares. The value of the A. Better Mousetrap, Inc. at the death of Anthony was \$2,000,000. Thus, each Shareholder’s basis in their stock in A. Better Mousetrap, Inc. was \$666,667.<sup>5</sup>

---

<sup>3</sup> Any resemblances to any living individual is strictly coincidental

<sup>4</sup> Query, what is a timely death?

<sup>5</sup> Sue me for not including cents!

Under Steve's leadership, A. Better Mousetrap, Inc. continued to prosper. Ed continued in the banking arena and Rich returned from the "old country" but retained his playboy lifestyle. Business continued to be good and, except for a small problem with a few of the mousetraps that resulted in the severing of small children's limbs, everything was great. However, by the present day, Steve was becoming increasingly tired of working in the business while Ed and Rich reaped 2/3's of the Company's profits. After unsuccessfully attempting to buy his brothers out on a number of occasions and while waiting with his attorney to bail Rich out of jail after another "incident", Steve received a call from David Inhuman, President and CEO of Inhuman Industries, Inc.

"Steve, how are you? David Inhuman here, we met several years ago at an awards ceremony in Las Vegas. Steve, let me get to the point, I want to buy A. Better Mousetrap, Inc. from you and your brothers and make it a part of Inhuman Industries, Inc."

"Not for sale" said Steve.

"Don't be ridiculous Steve, name your price" said David

"Twenty million" quips Steve "I think I can get Ed and Rich to go along with that"

"Sold" says David, "I'll have my attorney call yours"

Steve hangs up the phone and turns to his attorney and says, "Is there anything I should be concerned with in selling A. Better Mousetrap, Inc.? His attorney shrugs his shoulders and says, "I don't know, I'm just a white collar crime lawyer" Talk to \_\_\_\_\_<sup>6</sup> in our \_\_\_\_\_<sup>6</sup> office. He/she is an expert on this.

The next day you get the call from Steve

"Can you help me" Steve says

---

<sup>6</sup> Fill in your name here

<sup>6</sup> Fill in your location here

“Sure” you say, “are you selling the stock or assets of A. Better Mousetrap, Inc. to Inhuman Industries, Inc.?”

“Does it matter?” says Steve.

“Quite a bit” you say “can you meet me today so we can go over it”

“Sure” Steve says “but I am geographically challenged, can you give me good directions”

“Of course” you say, “before attending law school I was a professional map reader. Also bring a balance sheet for A. Better Mousetrap, Inc.”<sup>8</sup>

Later that day you receive the following.

---

<sup>8</sup> If you have to ask “what is a balance sheet?” get up, leave the room, and join the litigation group.

A. Better Mousetrap, Inc.

12/31/02

<u>Assets</u>		<u>Liabilities &amp; Stockholder's Equity</u>	
Cash	\$700,000	Accounts Payable	\$1,500,000
Plant and equipment	\$2,500,000	Bank Debt	\$3,000,000
Accounts Receivable	\$2,000,000	Total liabilities	<u>\$4,500,000</u>
Inventory	\$3,000,000	Stockholders' equity	\$3,700,000
<u>Total</u>	<u>\$8,200,000</u>	Total	<u>\$8,200,000</u>

Tax Analysis of Stock Sale vs. Asset Sale

Sellers' Perspective<sup>9</sup>

- A. Assumptions (used throughout these examples unless otherwise noted)
1. Individual income tax rate, blended federal and state 44.6%.
  2. Individual Long Term Capital gain rate, blended federal and state 26%.
  3. Corporate blended income tax rate 38%.
  4. A. Better Mousetrap, Inc. uses the accrual method of accounting.
  5. A. Better Mousetrap, Inc. basis for book purposes equals its adjusted basis for tax purposes.

<sup>9</sup> A/k/a "how much cash will I walk away with"



6. A. Better Mousetrap, Inc. is a C corporation.

B. Stock Sale \$20,000,000<sup>10</sup>

Cash to Steve, Ed and Rich \$3,996,667

Calculated as follows

Sale price per Shareholder	\$5,166,667
Less Basis	\$666,667
Capital gain on sale	\$4,500,000
Capital gain rate	26%
Long term Capital gain Tax	\$1,170,000
Cash Left	\$3,996,667

C. Asset Sale for \$20,000,000 (Step1) followed by a liquidation of A. Better Mousetrap, Inc. (Step 2)

Cash to Steve, Ed and Rich \$3,260, 613

Calculated as follows

Step 1

Sale price of Assets	\$20,000,000
Book Value	\$8,200,000
Gain	\$11,800,000
Tax 38%	\$4,484,000

Step 2

---

<sup>10</sup> In order to compare “apples to apples” with the next example, this example assumes a sale price of \$20,000,000 less the liabilities assumed as part of the stock purchase

Cash Left in Corp. <sup>11</sup>	\$12,516,000
Divided by three	\$4,172,000
Less Basis in stock	\$666,667
Capital gain	\$3,503,333
Capital Gain Tax 26%	\$911,387
Cash to Shareholders	\$3,260,613

D. The difference between a stock sale and asset sale is \$736,054 per shareholder.

#### Tax and Practical Analysis of

#### Stock vs. Asset Sale

#### Buyer's Perspective

So, if there is such a difference from the Sellers' perspective between a asset sale as opposed to a stock sale why don't Buyers want to go along with a stock sale? The answer is twofold, tax and liability

#### A. Tax

From an income tax stand point, the principal reason Buyers don't like stock deals is because of basis and specifically carry over basis. In a stock purchase transaction the Buyer gets no increase in its cost basis for the assets of the corporation purchased. Thus, in the above example, after the sale of the stock of A. Better Mouse Trap, Inc., Inhuman Industries Inc. would have to carry the assets of A. Better Mouse Trap, Inc. on its books (and for tax purposes) at the same value that A. Better Mouse Trap, Inc. did prior to the stock sale. In an

<sup>11</sup> \$20,000,000 less tax (\$4,484,000) and Liabilities paid (\$3,000,000)



asset sale the Buyer is entitled to step up the basis of the assets purchased to their fair market based upon the purchase price allocation as agreed to by the Buyer and Seller and as included on the form 8594 filed by both Buyer and Seller with the IRS. Thus, Buyer can begin depreciating the stepped up basis of the hard assets purchased and amortizing the intangible assets purchased on Buyer's income tax returns.

B. Liability Concerns

Perhaps even more important than the Tax reasons for Buyers not liking stock purchase transactions is the liability issues raised in a Stock purchase. In an Asset sale, the Buyer only buys those assets and assumes those liabilities specifically include in the definitive purchase agreement. On the other hand, in a stock purchase, the Buyer assumes all liabilities both known and unknown. Thus, in the example above, if Inhuman Industries, Inc. purchased all of the stock of A. Better Mouse Trap, Inc., then all of the liabilities on the books of A. Better Mouse Trap, Inc. and those unknown liabilities, such as those associated with the limb removing mousetraps, would become liabilities of Inhuman Industries, Inc.

Section 338

Under Section 338(g) of the Internal Revenue Code of 1986 a Qualified Purchaser of stock in a corporation can make an election after the purchase of the stock to increase the basis of the assets of the corporation purchased to their fair market value on the date of the purchase. When the Buyer makes this election, the purchased corporation is deemed to have sold its assets at the purchase price for the stock and therefore income tax will be owed by the purchased corporation (payable by Buyer) on the difference between the deemed purchase price of the assets (the stock purchase price) and their depreciated tax basis at the date of the acquisition. From, the Buyer's perspective, the 338(g) election usually only

makes sense if the asset value shown on the books is low and the Seller has tax attributes such as a Net Operating Loss which would otherwise be limited or suspended under § 382 of the Code and the Buyer to agree to a purchase price reduction in order to do the deal. Thus, in the first example above if we assume that Inhuman Industries, Inc. agreed to do the deal only if the shareholders of A. Better Mousetrap, Inc agreed to a purchase price adjustment equal to the tax owed if Inhuman Industries, Inc. made an election under Section 338(g) and further that A. Better Mousetrap, Inc. had a NOL of \$5,000,000<sup>12</sup> then A. Better Mouse Trap, Inc. would owe income tax of \$4,484,000 calculated as follows:

Fair Market Value of Assets	\$20,000,000
Less Book Value	\$8,200,000
Less NOL	\$5,000,000
Taxable Gain	\$6,800,000
Tax (at 38%)	\$2,584,000

The resulting cash to Steve, Ed and Rich would be \$3,359,280 calculated as follows:

Purchase Price	\$20,000,000
Less price adjustment for taxes	\$2,584,000
Less assumed liabilities	\$4,500,000
Less basis	\$2,000,000
Taxable gain	\$10,916,000
Tax 26%	\$2,838,160
Cash remaining	\$10,077,840
Cash to each Shareholder	\$3,359,280

<sup>12</sup> Directly related to the 2 two years Rich was running the company while Steve was in the USO in Bosnia

Thus to recap, a straight stock sale nets \$ 3,996,667 to each shareholder, an asset sale followed by a liquidation nets each shareholder \$3,260,613 and a stock sale, followed by a Section 338(g) election by Inhuman Industries with a purchase reduction equal to the tax nets each shareholder \$3,359,280. In each case, Inhuman Industries, Inc pays \$20,000,000 (or pays cash and assumes liabilities which equate to that) but the variations to the stockholders of A. Better Mouse Trap, Inc. are enormous.

### Variations on a Theme

In addition to the issues raised above at least two other considerations from a tax perspective need to be considered in context of any proposed acquisition.

#### A. Deducting Part of the Purchase Price

Whether the transaction is an asset purchase or a stock purchase the nature of the transaction in either case is a capital expenditure by the purchaser. Thus the purchase price paid is not a deductible item for purposes of the purchaser's income taxes<sup>13</sup>. As such, many times purchasers will try and shift part of the over all consideration paid to a deductible expense.

Thus for example, suppose David Inhuman responded to Steve's \$20,000,000 offer to sale as follows:

“Steve, I'll pay your price but I want you to stay on and run the company. I'll triple your salary and give you a 5-year contract, but what we will pay you to run the company is part of the purchase price we are willing to pay. Also, because you know all the secrets to making good mousetraps, you will have to sign a non compete agreement with Inhuman

---

<sup>13</sup> Again, in an assets purchase the purchaser would be entitled to depreciation and amortization deductions for the assets purchased



Industries, Inc. as part of the sale and we will pay you \$2,000,000 for it which prohibits you from getting back in the mousetrap business for 3 years after your employment with the company ends.

Since Steve was currently making \$200,000 a year, this seemed like a good deal. Also, Ed and Rich agreed that it was only fair for Steve since he had been running A. Better Mouse Trap, Inc. for all these years, that he get a bigger cut of the sale. Assuming the deal is a stock deal, then the result is as follows:

Cash from stock sale to Ed, Steve and Rich \$2,763,333 calculated as follows

Sale Price	\$20,000,000
Less employment Agreement	\$3,000,000
Less Non Compete	\$2,000,000
Less Assumed Liabilities	\$4,500,000
Net Sale Price	\$10,500,000
Less Basis	\$2,000,000
Capital gain on sale	\$8,500,000
X Capital gain rate	26%
Capital gain Tax	\$2,210,000
Cash Left	\$8,290,000
Cash to each Shareholder	\$2,763,333

Additional cash to Steve in this example equals \$2,770,000 (\$5,000,000 reduced by income taxes). That totals \$5,533,333 to him. In addition, Inhuman Industries Inc. gets to deduct Steve's salary each year paid and can amortize the non compete agreement over a 15

year period thereby making 25% of the purchase price deductible, albeit with respect to the non compete over 15 years

B. Section 338(h)(10)

One other avenue to consider in an acquisition, which is not available in this example is the use of a Section 338(h)(10) election by a buyer and seller. Essentially a §338(h)(10) is a joint election by a buyer and seller of stock whereby the stock sale is ignored for income tax purposes and the selling corporation is treated as selling its assets for their fair market value to the purchaser followed by a liquidating distribution by the selling corporation to its shareholders. The result is a single level tax at the seller's level, and a step up in basis for the assets at the buyer's level. A §338(h)(10) election may not be recognized for state income tax purposes in states that do not "piggyback" on federal income tax laws and as such it must be considered. In addition, a §338(h)(10) election can only be made where the seller is a domestic corporation which is the parent of the target corporation being sold or the shareholders of an S corporation. A §338(h)(10) election and the circumstances behind its use are extremely complex and complicated and should not be undertaken without proper consultation.

::ODMA\PCDOCS\ST\_LOUIS\793121\1