

KEY TAX INSIGHTS

MERGERS & ACQUISITIONS NEWSLETTER

MEMBERSHIP INTEREST FOR SERVICES AND PURCHASER'S TAX LIABILITY



The after-tax proceeds of the sale of a business is of the utmost importance to sellers. Too often sellers agree to holdbacks or a reduction in purchase price for alleged tax issues raised by the purchaser during due diligence where the purchaser bears no actual risk. The seller who has spent years of their blood, sweat, and tears growing the business is now reducing the purchase price unnecessarily for alleged tax liabilities. We have a unique team that allows us to provide the customized advice to these business owners to keep the hard-earned value of the company with the sellers.

In this acquisition, the purchaser attempted to reduce the purchase price by more than \$3.5 million on certain tax issues on a \$20 million acquisition ("Purchase Price"). If the purchaser was successful, this would have reduced the Purchase Price by 17.5 percent. The purchaser was a publicly traded corporation with in-house tax counsel, big law tax department representation, and an international tax consulting firm handling the due diligence (collectively, the "Purchaser's Tax Team").

The target company was a partnership for income tax purposes. There were three partners in the company with two partners having received their interest four years prior to the acquisition. These two partners were not employees of the company, but had particular expertise to prepare the company for acquisition. Purchaser's Tax Team zeroed in on these two partners allegedly receiving interest for services as a W-2 payroll tax withholding issue ("Payroll Tax Issue") and placed a \$2 million price tag on this issue.

In providing the proposed value of the company at the time these two partners received their interest in the company, the Purchaser's Tax Team used a superfluous value simply stating the value was half the Purchase Price for the acquisition. The sellers did not agree that the two partners received interest for services.

Instead of engaging the Purchaser's Tax Team in arbitrary discussions about the value of the company four years prior to acquisition or whether the partners received interest for services, we directed the conversation to whether this was a payroll tax issue. During the second meeting with Purchaser's Tax Team, we asked whether partners in a partnership receive a K-1 or W-2. The Purchaser's Tax Team seemed confused and ignored the question. When we posed the question during the next meeting, Purchaser's Tax Team created a new test that the tax treatment occurred a moment before receipt of the interest or a year before, their statements were inconsistent and incorrect.

Given Purchaser's Tax Team's unwillingness to listen, we finally had to prepare a memorandum that partners in a partnership receive a K-1 and not a W-2 and provide legal support that if the partners received interest for services, it was a K-1 issue. Ultimately, this means the purchaser would not be responsible for this alleged tax issue.

The sellers were able to remove the Payroll Tax Issue by focusing on whether the purchaser could be liable for the Payroll Tax Issue, instead of debating uncertain tax liabilities. This, in part also led to the sellers receiving the Purchase Price, with no reduction, in one payment instead of multiple payments over a number of years, significantly increasing the value received under the time value of money.

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