

# **Navigating the Tax Rules Pertaining to Sale/Transfer of Limited Liability Company Interests, Partnership Interests or Assets**

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# **Navigating the Tax Rules Pertaining to Sale/Transfer of Limited Liability Company Interests, Partnership Interests or Assets**

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# Navigating the Tax Rules Pertaining to Sale/Transfer of Limited Liability Company Interests, Partnership Interests and Assets Transfers

Regardless of the legal form and structure of a transaction, the primary consideration driving most conveyances of business assets is how the income from the sale is treated by the seller, as personal income or capital gains. From a buyer's perspective, many considerations involved are driven by the ability to amortize the expenses of the purchase over time and the ability to make payments over time and characterize them in certain ways. From a seller's perspective, one of the primary considerations is the cost basis of the interests being acquired.

Most practitioners would agree that there are really three parties in every transaction, the buyer, the seller and the IRS. The most important considerations in structuring a transaction is how to minimize the tax implications for all parties involved while ensuring a sufficient amount cash is transferring at the appropriate times to the seller.

These materials will explore a lawyer's negotiating points and items to consider when negotiating and structuring the sale and transfer of partnership interests and limited liability company units and the assets associated with those entities.

## I. PRIMARY TRANSFER CONSIDERATION.

**Characterization as Capital Gain v. Ordinary Income.** For individual taxpayers, gains from the sale of certain assets which qualify for the long-term capital gain treatment will generally be subjected to a maximum tax rate of 20%, with some exceptions.<sup>1</sup> In comparison, the maximum tax rate for ordinary income can rise to 39.6%.<sup>2</sup> The capital gain preference is often important because the assets may have increased substantially in value over several years and, upon the sale of the business, may cause substantial taxable gains to be "bunched" into a single year, thereby exposing the taxpayer to higher marginal tax rates. Capital gain income generally results from the sale of capital assets.<sup>3</sup> In addition, depreciable property and real property used in a trade or business held for more than one year will also enjoy capital gain treatment if the business assets are sold at a net gain.<sup>4</sup> The maximum tax rate applicable to specific assets will vary, depending upon the nature of the asset, because of the adoption of a multi-tier rate structure in 1977.

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<sup>1</sup> I.R.C. § 1(h).

<sup>2</sup> I.R.C. § 1.

<sup>3</sup> I.R.C. § 1221. "Capital assets" are defined as virtually all assets, except for specific types of assets. The important exclusions include inventory and assets used in a trade or business. I.R.C. § 1221.

<sup>4</sup> I.R.C. § 1231. The special treatment of I.R.C. § 1231 applies to "property used in the trade or business, of a character subject to the allowance for depreciation, provided in Section 167, held for more than 1 year, and real property used in the trade or business, held for more than 1 year. I.R.C. § 1231(b).

For example, the maximum tax rate on most capital gain income is 20%,<sup>5</sup> whereas the maximum tax rate on "unrecaptured section 1250 gain" is 25%.<sup>6</sup> If an individual business asset is sold at a loss, the loss will be characterized as long term capital loss if all of the business assets are sold at a net gain.

## II. SALE OF PARTNERSHIP INTERESTS.

A partner who sells or exchanges his/her partnership interest is typically deemed to be a transfer of a discrete asset rather than a share of each item of the property owned by the partnership. A partnership interest ordinarily is a capital asset and a partner selling the same, typically realizes a capital gain or loss on its sale.<sup>7</sup> The IRS does provide a set of rules designed to prevent conversion of the selling partner's share of the partnership's unrealized ordinary income into capital gain.

**A. RECOGNIZING GAIN AND LOSS.** Under I.R.C. Sections 741 and 751, a sale of a partnership is divided into two parts:

1. The seller recognizes ordinary income or loss on the portion of the sale attributable to his share of the partnership's unrealized receivables and substantially appreciated inventory; and<sup>8</sup>
2. The seller recognizes capital gain or loss on the portion of the sale attributable to his/her share of all other partnership property.<sup>9</sup>

The I.R.C. defines both "unrealized receivables" and "inventory." "Unrealized receivables" refers to accounts receivable arising from the sale of goods (delivered or to be delivered)<sup>10</sup> and services (rendered or to be rendered)." The term applies generally to cash method partnerships because accrual method partnerships would already have reported the accounts as ordinary income at the time of their accrual, and there would be no opportunity to convert ordinary income into capital gain income. The term "inventory" refers to property that is held by the partnership as stock in trade or property held primarily for sale to customers in the ordinary course of a trade or business,<sup>11</sup> as well as other property that would not qualify for the preferential treatment afforded to capital assets and Section 1231 assets. The Taxpayer's Relief Act of 1997 broadened the application of I.R.C. § 751 and now applies to the sale/exchange (but not disproportionate distributions) of an interest in a partnership that holds any

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<sup>5</sup> I.R.C. § 1(h)(1)(E).

<sup>6</sup> I.R.C. § 1(h)(1)(B).

<sup>7</sup> I.R.C. §741.

<sup>8</sup> I.R.C. § 751.

<sup>9</sup> I.R.C. § 741.

<sup>10</sup> I.R.C. § 751(c).

<sup>11</sup> I.R.C. § 751(d).

inventory items, whether or not the inventory has substantially appreciated in value.

**B. CALCULATION OF GAIN OR LOSS.** The calculation of the gain or loss from a disposition of a partnership interest is governed by Sections 722 and 742.

**C. LOOKING AT TAX BASIS FROM A PURCHASER'S PERSPECTIVE.**

The purchaser of a partnership interest receives a cost basis in the partnership interest,<sup>12</sup> which is referred to as the "outside" basis. The partnership is viewed as an entity to the extent the incoming partner acquires a basis in his/her partnership interest that is unrelated to the partnership's basis in its assets, which is referred to as the "inside" basis. The "outside" basis will be increased by the new partner's share of partnership liabilities.<sup>13</sup> The purchaser(s) may be treated as having purchased either the outstanding partnership interests or the assets of the partnership. In most instances involving the termination of the former partnership, it makes no significant difference to the purchaser(s) whether the sale of the partnership's business is viewed as either (1) a sale of assets by the partnership; or (2) a sale of the various partnership interests by the partners. If there are two or more purchasers, the purchase acquisition results in the formation of a new partnership. If there is only a single purchaser, the business would be treated either as a sole proprietorship or an entity enterprise if purchased by a corporation or a limited liability company. It should be noted, however, that there could be a difference in the basis of the assets purchased by the purchaser, depending upon the structure adopted.

**D. WHEN A NEW PARTNER COMES ON BOARD - SECTION 754 BASIS**

**MATTERS.** When there is a portion of the partnership that is sold to a new incoming partner, issues may arise pertaining to the basis allocated to each due to the discrepancy of the assets contributed. This may be alleviated if the partnership makes a Section 754 election to adjust the basis of its assets.<sup>14</sup> If the partnership has made a Section 754 election, it may increase (or decrease) the adjusted basis of its assets to reflect the fair market value basis of the new partner's interest in the partnership. This election permits the partnership to adjust the basis of each of its assets to reflect a portion of the assets' fair market value and, thereby, alleviate the distortion that would otherwise occur for an incoming partner who purchased his/her partnership interest for fair market value. The election results in a reduction of the taxable gains (and losses) on the sale of assets that would otherwise be allocated to an incoming partner who purchased a

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<sup>12</sup> I.R.C. §§ 742, 1012.

<sup>13</sup> I.R.C. § 752(a).

<sup>14</sup> I.R.C. §§ 743, 754.

proportional interest in the assets for a price equivalent to their fair market value.<sup>15</sup>

**E. INSTALLMENT REPORTING.** The application of I.R.C. § 751, which converts potential capital gain into ordinary income, also impacts the former partner's reporting method. Installment reporting under I.R.C. § 453 is generally unavailable to inventory and depreciation recapture.<sup>16</sup> To the extent that I.R.C. § 751 converts income to ordinary income for gains, the selling partner may not report the Section 751 gain under the installment method.<sup>17</sup>

**F. TERMINATION OF A PARTNERSHIP.** A termination of a partnership may be triggered by the sale of partnership interests. The sale of a partnership business can be accomplished through the sale of all of the partnership interests, thereby resulting in a termination of the partnership. In most instances, the partners and the partnership are indifferent whether the transaction is treated as a sale of the business assets by the partnership or a sale of all of the outstanding partnership interests. Regardless of which method is adopted for the transaction, the partners will recognize ordinary income on the unrealized receivables and inventory held by the partnership, and will recognize capital gain income on the balance of the transaction. In some instances, a sale/exchange of a single partnership interest may trigger an automatic dissolution of the partnership, affecting both the selling partner as well as the continuing partners.<sup>18</sup> A partnership is terminated for tax purposes if: (1) no part of any business, financial operation, or venture continues to be carried on by any of its partners,<sup>19</sup> or (2) there is a sale or exchange of 50% or more of the total interest in capital and profits of the partnership within a 12 month period.<sup>20</sup> Upon termination of the partnership, the partnership's taxable year closes with respect to all partners. As a result, the former partnership is deemed liquidated and its assets are deemed distributed to its former partners.

**G. REPORTING.** A Form 8308 must be filed for each sale or exchange of a partnership interest where the partnership has IRC Section 751 property designated. Form 8308 is attached to these materials as *Exhibit A*. The form must be filed in the tax year in which the exchange/sale took place.

**H. EXCHANGE OF A PARTNERSHIP INTEREST.** A like-kind exchange of a partnership interest is not allowable under Section 1031 of the I.R.C. There are however, tax-free exchanges of partnership interests to convert the same to other

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<sup>15</sup> Rev. Rul. 86-73.

<sup>16</sup> I.R.C. § 453(b)(2)(A) and I.R.C. § 453(i).

<sup>17</sup> Rev. Rul. 89-108.

<sup>18</sup> I.R.C. § 708(b).

<sup>19</sup> I.R.C. § 708(b)(1)(A).

<sup>20</sup> I.R.C. § 708(b)(1)(B).

types of business interests or as a contribution of capital to a new business structure.

- I. GUIDE.** Look to IRS Audit Technique Guide, Chapter 7 for a good “rule book” to follow on how disposition of partnership interests are audited and regulated by the IRS. A copy of the same is attached to these materials as *Exhibit B*.

**III. HOW TO STRUCTURE THE SALE – ASSET SALE V. UNIT/ENTITY SALE. SELLING THE FARM OR SELLING THE FAMILY NAME? WHAT IS YOUR CLIENT BUYING/SELLING?**

**A. ASSET SALE** - Stepped up in basis of purchased assets.

**B. ENTITY SALE**

1. Seller - taxed at one level of taxation at a long term capital gains rate of 15%.
2. Buyer - basis equivalent to amount paid for the units plus the acquisition costs.

**C. BASIS OF ASSETS.** The buyer naturally seeks to maximize the favorable tax attributes acquired upon the purchase of a closely-held business and the assets pertaining to the same. One of the major concerns is the relative cost basis for each of the assets acquired. The buyer’s basis in assets is determined by the cost of the asset<sup>21</sup> which is commonly a matter of negotiation among the parties and is important in the determination of the purchaser's future depreciation deductions.<sup>22</sup>

**D. PRACTITIONER’S CHECKLIST.**

**IV. HOW TO STRUCTURE AND NEGOTIATE THE ALLOCATION OF PURCHASE PRICE IN AN ASSET SALE.**

Allocating the purchase price (total sale price) of a business amongst the various asset components of a business is necessary when a business is sold. In the sale of a business, one of the assets sold is the ongoing concern and the sale of the tangible and intangible assets of the business entity. Since the sale involves the individual assets, the sales price must be allocated among the various assets.<sup>23</sup>

For the seller, the allocation of the sales price determines the amount realized upon each asset, and thereby determines the amount and character of gains and losses realized from

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<sup>21</sup> I.R.C. § 1012.

<sup>22</sup> I.R.C. §§ 168, 1016.

<sup>23</sup> I.R.C. § 1060(a).

the sale of each asset. Therefore, the allocation is important in determining the amount of capital gain on each asset, as well as the relevant capital gain tax rate applicable to the gain on each asset. For the buyer, the same allocation determines the buyer's cost basis in the various assets which, in turn, determines the amount and timing of the buyer's depreciation and expense deductions.<sup>24</sup> As discussed below, a price allocation that favors the seller may not necessarily favor the purchaser, and the practitioner should anticipate negotiations over how the total sale/purchase price will be allocated among the various business assets.

With respect to the allocation of purchase price, the first consideration is usually whether the sale is to be a membership unit sale or an asset sale. Allocating the purchase price to specific assets in a business acquisition is part science and part art. The science comes into play with regard to following the rules that the Internal Revenue Service has established, as well as documenting the assumptions and support that were used. The art comes into play with regard to allocating value to the intangible assets that are present in most ongoing businesses. The primary considerations include the following:

1. Internal Revenue Code (IRC) 1060 and Reporting Requirements (Form 8594)
2. Hard ("tangible") assets
3. Intangible assets
4. The real world (purchase price negotiated first, then the pieces are given values)

It is important that both the seller's and the buyer's tax advisors are consulted when the allocation is being negotiated. Frequently, the allocation of purchase price can become another area of negotiation after the price, terms, and conditions of the sale have been agreed to by the buyer and seller. These negotiations can be as critical as the purchase price negotiations.

Any sale typically involves all the assets of the business including, but not limited to all equipment, trade fixtures, leaseholds, leasehold improvements, contract rights, business records (with seller retaining a reasonable right of inspection), licenses, franchises, customer list, goodwill, covenant not to compete, trade secrets, trade names, telephone numbers, suppliers, work in progress, saleable and consumable inventories, plus training for future management of the business from the primary owner(s). An asset sale typically does not involve accounts receivable, bank accounts, deposits, cash, or most business liabilities.

**A. TYPES OF ASSETS.** When the buyers are purchasing the tangible and intangible the purchase price is usually allocated to some, or all, of the following components:

1. Tangible Personal Property (trade fixtures, furniture, equipment)

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<sup>24</sup> I.R.C.. §§ 167 & 168 (providing for the depreciation deductions) and I.R.C. § 179 (providing for an expense deduction).

2. Leasehold Improvements
3. Value of Premise Lease (if the lease is at or below market rent)
4. Covenant Not to Compete (include time and distance of covenant)
5. Training and Transition (include schedule of time, hours, etc.)
6. Liquor License (include license type and number)
7. Customer List
8. Goodwill
9. Buildings
10. Land
11. Inventory

The total value allocated to all of the appropriate assets should equal the total of the purchase price. IRC Section 1060 further delineates specific items included in each of the seven "classes" of assets.

**B. SELLER'S TAX CONSIDERATIONS.** A seller generally seeks to structure the transaction to maximize the potential capital gain income. Sellers seek to maximize the capital gain by allocating a greater portion of the sales price to those assets with the greatest potential for reporting capital gain income. In addition, with the advent of the multiple rate structure that now applies to capital gains, sellers can be expected to allocate more of the sales price to those assets that enjoy the lowest capital gain tax rate. Those assets usually include the following: (1) land, (2) capital assets, with its multiple tax rate structure, (3) buildings<sup>25</sup>, and (4) depreciable personal property, such as fixtures and equipment.<sup>26</sup>

**C. BUYER'S TAX CONSIDERATIONS.** A buyer will attempt to minimize taxable income from operations through the use of appropriate expense deductions (such as depreciation or inventory expenses), and seek to increase the price allocations to those assets. A buyer may negotiate an allocation that places the highest possible cost basis in inventory, thereby maximizing the "cost of goods sold" for the first year of operations and minimizing taxable income, with the costs allocated to the purchase of inventory offsetting "ordinary income," and providing tax savings at the taxpayer's highest marginal tax rate. Similarly, a buyer may attempt to maximize depreciation deductions by maximizing the cost basis of depreciable assets and minimizing the cost basis of nondepreciable assets.<sup>27</sup>

For depreciable assets, a buyer generally seeks to maximize the potential depreciation deductions by allocating a greater portion of the purchase price to those assets with the shortest recovery periods, thereby accelerating the tax savings from

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<sup>25</sup> I.R.C. § 1250.

<sup>26</sup> I.R.C. § 1245.

<sup>27</sup> I.R.C. § 1012.

depreciation.<sup>28</sup> The buyer's price allocation will also be affected by the availability of the expensing election. This election applies to personal property.<sup>29</sup>

#### **D. SUMMARY CHECKLIST OF TAX IMPLICATIONS PERTAINING TO ASSET ALLOCATION.**

1. Membership Units:
  - a. Seller: Capital gains tax rate (currently at 15%) for stock held more than one year
  - b. Buyer: No write off; must accept assets at current book value (i.e., existing depreciation schedule)
2. Covenant Not to Compete
  - a. Seller: Ordinary income to recipient (is considered personal to seller / principal)
  - b. Buyer: Amortize value over 15 years
3. Training / Consulting Agreement:
  - c. Seller – Ordinary income
  - d. Buyer- Expense out as paid
4. Tangible Personal Property (trade fixtures, furniture, equipment)
  - e. Seller: If held more than one year, the gains in excess of depreciation are long-term capital gain; otherwise ordinary income
  - f. Buyer: Established basis, depreciate per IRS schedules
5. Premise Lease (if the lease is at below market rent, it is an intangible asset):
  1. Seller: If held for more than one year, is long-term capital gain
  2. Buyer: Amortize value over 15 years
6. Covenant Not to Compete
  1. Seller: Ordinary income as received
  2. Buyer: Amortize over 15 years
7. Registered Vehicles (do not include in Tangible Personal Property above):
  1. Seller: If held more than one year, the gains in excess of depreciation are long-term capital gain; otherwise ordinary income
  2. Buyer: Established basis, depreciate per IRS schedules
8. Liquor License (include license type and number; is an intangible asset):
  1. Seller: If held for more than one year, is long-term capital gain
  2. Buyer: Amortize over 15 years
9. Customer List:
  1. Seller: Ordinary income as received
  2. Buyer: Amortize over 15 years
10. Goodwill:
  1. Seller: If held for more than one year, is long-term capital gain
  2. Buyer: Amortize over 15 years

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<sup>28</sup> I.R.C. §§ 167 and 168..

<sup>29</sup> I.R.C. §§ 179, 1245(a)(3).

11. Buildings:

1. Seller: If held more than one year, the gains in excess of depreciation are long-term capital gain; otherwise ordinary income
2. Buyer: Establishes basis, depreciate per IRS schedules

12. Land:

1. Seller: If held more than one year, the gains in excess of depreciation are long-term capital gain, otherwise ordinary income
2. Buyer: No immediate tax impacts

13. Inventory:

1. Seller: Ordinary income, to the extent that is over basis
2. Buyer: Treated as "cost of goods sold" upon sale of products

**E. INFORMATION REPORTING.** The seller and buyer in a transaction involving the acquisition of a trade or business are required to file Form 8594 (a copy of which is attached to these materials as *Exhibit C*), including any modifications that take place in a subsequent year on account of any modifications to the transaction.<sup>30</sup> Both the seller and the buyer must file the form, which is to be attached to their respective tax return for the year in which the acquisition was made. The amounts included in the report are relevant to both the buyer's basis in the assets purchased, as well as the gain/loss reported by the seller.

**F. FAIR MARKET VALUE ALLOCATIONS.** Since the sale involves a sale of the individual assets, the sales/purchase price must be "allocated" among the assets in accordance with their relative fair market value.<sup>31</sup> "Fair market value" is generally defined as "the price arrived at by a willing buyer and a willing seller, neither being under a compulsion to buy or sell." An asset's fair market value is based upon the gross value of an asset, determined without regard to mortgages, liens, pledges, or other liabilities.

**V. HOW TO STRUCTURE THE PAYMENT TERMS - SHOW ME THE MONEY – NOW OR LATER – WHICH IS BETTER?** It is surprising to many that very few deals are structured as a 100% cash sale where the seller receives a huge check at closing, and walks away with cash in his pocket. This is a rare occurrence. The typical transaction is structured with some form of "carry back" where there is a loan to the buyer and the seller carries back part of the purchase price over time. There are tax reasons that this makes sense, particularly from a Seller's perspective. From a buyer's perspective, the ability to come up with less cash up front allows greater flexibility to put money into the business operations initially.

The following should be considered when structuring what do with the income payments due to the seller:

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<sup>30</sup> I.R.C. § 1060.

<sup>31</sup> I.R.C. § 1060(f).

**A. INSTALLMENT PURCHASE.** This is one of the most common types of structures for the sale of business assets or business interests. A portion of the purchase price is paid in the form of a down payment and then installment payments are made over time. The seller receives a promissory note to document the payment terms for the remainder of the payments. The promissory note is treated as a loan and is further secured by the assets that the buyer is purchasing in the form of a UCC lien, membership unit assignment, mortgage or contract for deed, all depending on how the transaction is structured.

If the transaction involves any type of seller financing, preservation of the tax deferral benefits associated with installment payments becomes very important.<sup>32</sup> Installment reporting permits the seller to report taxable gain periodically as payments are received. If installment reporting is unavailable, a seller must generally report the full amount of gain in the year of sale whether or not actual payments are deferred under an installment agreement with the purchaser. Installment reporting is unavailable for gains attributable to certain types of assets, including assets which are subject to depreciation recapture<sup>33</sup> and inventory.<sup>34</sup>

**B. BALLOON PAYMENT.** This type of structure is similar to an installment sale, except that instead of regular payments over time, a single payment is structured at some point over time, typically years out from the date of the original sale.

**C. COVENANT NOT TO COMPETE.** A portion of the purchase price can be allocated over time to a payment under a covenant not to compete. The payment can be paid in installments and allocated as set forth above. The additional benefit to the Buyer is that the buyer can amortize over 15 years on their tax return, even though the term is typically much shorter in duration or the buyer can deduct the payments in the year paid.

**D. EMPLOYMENT AGREEMENTS.** This would be characterized as a personal services agreement and would allow some flexibility on both sides of the transaction. It also allows the parties to structure ongoing benefits to the Seller and to maintain certain trade organization positions, travel, etc. This can all be included in an employment arrangement, allowing the seller to maintain some contact with the industry, allow for ongoing training and transition of the company.

1. BUYER – the buyer would be able to write off payments as a payroll expense.

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<sup>32</sup> I.R.C. § 453.

<sup>33</sup> I.R.C. § 453(i.)

<sup>34</sup> I.R.C. § 453(b)(2)(B).

2. SELLER – would have to declare the money received as regular income and would not be able to be taxed at a capital gains rate.

**E. CONSULTING AGREEMENTS.** Structuring part of the compensation in the form of a consulting agreement allows the buyer to defer some of the payment of the purchase price into the year in which the consulting agreement was performed and allows the buyer to expense the payment in the year it was paid for tax purposes. There is some difficulty in being able to adequately describe the expectations of the parties going forward and a tight agreement needs to set these forth succinctly.

**DRAFTING CONSIDERATIONS** – draft any employment or consulting agreement independent of the Sale Agreement so you don't end up with cross default issues – i.e. termination of employment agreement and cross-claim for breach of sale agreement.