

Chapter 15: Selling a Business: Asset vs. Stock Sale

The purchase price of a business can depend on whether or not the sale is a stock or asset sale. For corporations, sellers always want to sell stock, while buyers always want an asset sale. While contingent liabilities are a factor, the sale preference by the buyer and seller is almost always contingent upon the tax ramifications of each type of transaction.

Introduction

There are different methods to structuring a deal, such as mergers, consolidations, ESOP assisted deals, stock swaps, recapitalizations, all cash deals, installment sales, tax-free sales, and on and on. However, most small business sales are typically divided into a stock or an asset sale. These types of sales represent perhaps 80-90% of all middle market transactions and are the focus of this chapter.

Asset and Stock Sale

Most buyers will only purchase the assets of a business when it has limited management (1 or 2 key people), and no special niche in the market. At the other end of the spectrum are companies with a diverse management team, strong sales force, and a market niche. This second type of company has a management team which will most probably stay after a sale. In this case buyers will typically purchase the stock or assets, but will pay higher multiples of earnings.

When selling a corporation, one must decide whether the company should be sold based upon an asset sale or a stock sale. Partnerships and sole proprietorships are only sold based upon an asset sale. The dilemma and complexity arises when a corporation (C or S) sells its assets or stock. In the case of corporations, differences between the two sale methods result in substantial differences in taxes. For a corporation, the legal and tax ramifications can be seen in Table 15-1. These tax and legal issues will be discussed later in the chapter.

Table 15-1: Tax Versus Legal Aspects of Different Types of Sales

		Legal	
		Stock	Assets
Tax Issues	Nontaxable Sale	Type A Reorganization Type B Reorganization	Type C Reorganization
	Taxable Sale	338 Transaction Stock Sale	Asset Acquisition

The buyer’s and seller’s positions in an asset versus a stock sale, are summarized in Table 15-2 and Table 15-3.

Table 15-2: Buyer and Seller Position on a Stock Sale

	Buyer Position	Seller Position
Accounting/Tax Aspects	Bad: No step-up in basis; recapture tax on presale depreciation and investment tax credits; but allows retention of accounting methods, and NOLs (net operating losses) based upon restrictions.	Good: Avoids double taxation at the corporate and shareholder level; provides capital gain/loss so that there is no need to calculate gain or loss by each asset; avoids ordinary gain; essentially makes corporate level tax consequences a buyer’s problem.
Transaction Complexity	Less complex; transaction costs are less.	Requires shareholder approval; may require ex-spouse or other party approval.
Exposure	Does not terminate labor contracts or allow altering of employee benefits (such as unfunded employee benefit plans).	Transfers all or most obligations to buyer.
Insurance	Keeps liability, unemployment, and worker’s compensation insurance ratings.	
Financing	Lender needs to give consent to assumption of liabilities to buyer; but most likely debt structure can be retained.	
Other	Retains ownership of name; retains existing employee contracts and noncompete agreements; retains contractual obligations (leases, franchises).	Seller cannot retain certain assets, unless disposed of before the sale.

Table 15-3: Buyer and Seller Position on an Asset Sale

	Buyer Position	Seller Position
Accounting & Tax Aspects	Good: step-up in basis of assets is acquired for assets purchased (assuming purchase price is higher than seller's basis); higher future deductions. Recapture tax on presale depreciation and investment tax credit paid by seller.	Bad: taxed at corporate level, just as if company liquidated; also, gains/losses are based upon classification of each asset and its value.
Transaction Complexity	High: Difficult; nontransferable rights or assets cannot be transferred to buyer (e.g., franchise, patent); more costly (each asset transferred needs new title, state sales tax may apply); transaction costs are higher due to the need for additional accounting, legal and appraisal costs.	High: may require ex-spouse or other party approval; appraisals; financing.
Exposure	Limited, due to not assuming unknown contingent liabilities; also buyer can terminate or modify employment contracts, employee benefit plans, or collective bargaining agreements; allows buyer to avoid minority shareholder problems that arise with stock purchase.	High, due to responsibility of previous liabilities.
Insurance	Loss of liability, unemployment, worker's compensation rates.	
Financing	Lender needs to consent to assumption of liabilities.	Seller will most likely have to finance part of the purchase price.
Other	Buyer can pick and choose assets; buyer can change state of incorporation; buyer may lose right to use corporation's name; asset sale voids existing employee contracts and non-compete agreements (the flip side is your employees may soon be your new competitors); does not retain contractual obligations (leases, franchises).	

Aside from the preference for an asset sale by the buyer, due to the unknown liabilities of a corporation, the tax consequences for both the buyer and seller are of primary importance. The buyer wants an asset sale in order to step up the tax basis of the assets, while a seller wants a stock sale to avoid the double taxation (taxation on the asset basis and the stock basis). An example of these two conflicting tax issues can best be seen in an example.

Assume that company S is selling and that company B is buying. Assume that the sale price company of S is \$1,700,000. Steve (the owner, seller, and sole stockholder) has a basis in his stock of \$510,000, and an asset basis of \$170,000 (net of depreciation). The net (aftertax) proceeds to Steve, based upon either an asset sale or stock sale, might look something like that seen in Table 15-4.

Basic Example of Tax Consequences of Asset vs. Stock Sale

Table 15-4: Example of Seller Tax Consequences of Asset Versus Stock Sale

Assumptions					
Tax Basis in Assets	\$170,000				
Sale Price of Business	\$1,700,000				
Steve's Stock Basis	\$510,000				
Steve's Tax Rate	@ 28%				
Corporate Level Tax Rate	@ 15%				
	Stock Sale		Asset Sale		
Sale Price	\$1,700,000	\$1,700,000	\$1,700,000	\$1,700,000	\$1,700,000
Less: Asset Basis	-		(170,000)		
Less: Stock Basis	(510,000)		-		
Taxable Gain	\$1,190,000		\$1,530,000		
Times: Corporate Tax rate			@ 15%		
Tax (Corporate level)			(229,500)	(229,500)	(229,500)
			1,470,500		
Less: Stock basis	-		(510,000)		
Capital gain			960,500		
Times: Steve's tax rate	@ 28%		@ 28%		
Steve's Tax	(333,200)	(333,200)	(268,940)	(268,940)	(268,940)
Amount (net to Steve)	\$1,366,800		\$1,201,560		

Therefore, the stockholder would lose approximately \$165,240 (\$1,366,800 versus \$1,201,560) by going with an asset sale instead of a stock sale.

From the buyer's standpoint, he cannot receive the step up in basis on the assets if he has to purchase the stock. This means that he cannot start depreciating all of the assets from their *new* existing market value. From a bargaining standpoint, the buyer should run a present value analysis of the impact of not being able to obtain the step up in the basis of the assets.

Therefore, the buyer may purchase the assets for *more* than the \$1,700,000 price of the company, or a stock purchase for *less* than the \$1,700,000 of the company. For example, assume that the present value of the lost tax benefit resulting from the tax sale to be \$150,000 over 10 years (this is the loss by not being able to step up the value of the assets for tax depreciation purposes). Let us say that both buyer and seller contemplate either an asset sale or stock sale that will net Steve (stockholder and seller) +/- \$1,294,000. Therefore, the differences in sale price can be seen in Table 15-5.

Table 15-5: Effects of Differing Sale Prices Based Seller Tax Consequences

Assumptions						
Tax Basis in Assets	\$170,000					
Sale Price of Business	\$1,600,000 and \$1,850,000					
Steve's Stock Basis	\$510,000					
Steve's Tax Rate	@ 28%					
Corporate Level Tax Rate	@ 15%					
	Stock Sale			Asset Sale		
Sale Price	\$1,600,000	\$1,600,000		\$1,850,000	\$1,850,000	\$1,850,000
Less: Asset Basis				(170,000)		
Less: Stock Basis	(510,000)			-		
Taxable Gain	\$1,090,000			\$1,680,000		
Times: Corporate Tax rate				@ 15%		
Tax (Corporate level)				(252,000)	\$(252,000)	(252,000)
					1,598,000	
Less: Stock basis		-			(510,000)	
Taxable gain					1,088,000	
Times: Steve's tax rate		@ 28%			@ 28%	
Tax (Steve's rate)	(305,200)	(305,200)			(304,640)	(304,640)
Amount (net to Steve)		\$1,294,800				\$1,293,360

Table 15-6: Variations in Sale Price and Results to Steve

	Stock Sale	Asset Sale
Purchase Price	\$1,600,000	\$1,850,000
Aftertax Income to Steve (stockholder)	\$1,294,800	\$1,293,360

Comparing Table 15-4 and Table 15-5, assuming that the seller goes forward with a stock sale at \$1,600,000, Steve will only lose roughly \$72,000 (\$1,366,800 – \$1,294,800) rather than \$165,240 (\$1,366,800 net stock sale proceeds to Steve less \$1,201,560 net asset sale proceeds). Company B will only lose \$50,000, since Company B pays only \$1,600,000 instead of \$1,700,000. The \$50,000 is the present value loss of not being able to depreciate the step-up in basis (\$150,000), and is offset by the lower purchase price of \$100,000 (\$1,700,000 less \$1,600,000), leading to a loss of only \$50,000. **Therefore, the**