Deciding whether to structure a business sale as an asset sale or a stock sale is complicated because the parties involved benefit from opposing structures. Generally, buyers prefer asset sales, whereas sellers prefer stock sales. This article highlights some primary differences between the two structures.

This article is not intended to provide legal and/or tax advice. Every business transaction is unique, and buyers and sellers should always consult with the appropriate professionals (attorneys and accountants) when considering a business sale structure.

An asset sale is the purchase of individual assets and liabilities, whereas a stock sale is the purchase of the owner’s shares of a corporation. While there are many considerations when negotiating the type of transaction, tax implications and potential liabilities are the primary concerns. If the business in question is a sole proprietorship, a partnership, or a limited liability company (LLC), the transaction cannot be structured as a stock sale since none of these entity structures have stock. Instead, owners of these entity types can sell their partnership or membership interests as opposed to the entity selling its assets. If the business is incorporated, either as a regular C-corporation or as a sub-S corporation, the buyer and seller must decide whether to structure the deal as an asset sale or a stock sale.

**Asset Sales**

In an asset sale, the seller retains possession of the legal entity and the buyer purchases individual assets of the company, such as equipment, fixtures, leaseholds, licenses, goodwill, trade secrets, trade names, telephone numbers and inventory. Asset sales generally do not include cash and the seller typically retains the long-term debt obligations. This is commonly referred to as a cashfree, debt-free transaction. Normalized net working capital is also typically included in a sale. Net working capital often includes accounts receivable, inventory, prepaid expenses, accounts payable and accrued expenses.
BUYER’S VIEWPOINT
Within IRS guidelines, asset sales allow buyers to “stepup” the company’s depreciable basis in its assets. By allocating a higher value for assets that depreciate quickly (like equipment, which typically has a 3-7 year life) and by allocating lower values on assets that amortize slowly (like goodwill, which has a 15 year life), the buyer can gain additional tax benefits. This reduces taxes sooner and improves the company’s cash flow during the vital first years. In addition, buyers prefer asset sales because they more easily avoid inheriting potential liabilities, especially contingent liabilities in the form of product liability, contract disputes, product warranty issues, or employee lawsuits.

However, asset sales may also present problems for buyers. Certain assets are more difficult to transfer due to issues of assignability, legal ownership and third-party consents. Examples of more difficult to transfer assets include certain intellectual property, contracts, leases and permits. Obtaining consents and refiling permit applications can slow down the transaction process.

SELLER’S VIEWPOINT
For sellers, asset sales generate higher taxes because while intangible assets, such as goodwill, are taxed at capital gains rates, other “hard” assets can be subject to higher ordinary income tax rates. Federal capital gains rates are currently 20 percent and state rates vary (Missouri is currently 6 percent and Kansas is 4.8 percent). Ordinary income tax rates depend on the seller’s tax bracket.

Furthermore, if the entity sold is a C-corporation, the seller faces double taxation. The corporation is first taxed upon selling the assets to the buyer. The corporation’s owners are then taxed again when the proceeds transfer outside the corporation. In addition, if the company is an S-corporation that was formerly a C-corporation, and if the sale is within the 10-year built-in gains (BIG) tax recognition period, the S-corporation’s asset sale could trigger corporate-level BIG taxes, under IRS Sec. 1374.

Stock Sales
Through a stock sale, the buyer purchases the selling shareholders’ stock directly thereby obtaining ownership in the seller’s legal entity. The actual assets and liabilities acquired in a stock sale tend to be similar to that of an assets sale. Assets and liabilities not desired by the buyer will be distributed or paid off prior to the sale. Unlike an asset sale, stock sales do not require numerous separate conveyances of each individual asset because the title of each asset lies within the corporation.

BUYER’S VIEWPOINT
With stock sales, buyers lose the ability to gain a stepped up basis in the assets and thus do not get to re-depreciate certain assets. The basis of the assets at the time of sale, or book value, sets the depreciation basis for the new owner. As a result, the lower depreciation expense can result in higher future taxes for the buyer, as compared to an asset sale. Additionally, buyers may accept more risk by purchasing the company’s stock, including all contingent risk that may be unknown or undisclosed. Future lawsuits, environmental
concerns, OSHA violations, employee issues and other liabilities become the responsibility of the new owner. These potential liabilities can be mitigated in the stock purchase agreement through representations and warranties and indemnifications.

If the business in question has a large number of copyrights or patents or if it has significant government or corporate contracts that are difficult to assign, a stock sale may be the better option because the corporation, not the owner, retains ownership. Also, if a company is dependent on a few large vendors or customers, a stock sale may reduce the risk of losing these contracts.

SELLER’S VIEWPOINT

Sellers often favor stock sales because all the proceeds are taxed at a lower capital gains rate, and in C-corporations the corporate level taxes are bypassed. Likewise, sellers are sometimes less responsible for future liabilities, such as product liability claims, contract claims, employee lawsuits, pensions and benefit plans. However, the purchase agreement in a transaction can shift responsibilities back to a seller.

The deal structure of any transaction can have a major impact on the future for both the buyer and seller. Many other factors, such as the company’s structure and the industry, can also influence the decision. It is important for both parties to consult with their business intermediaries, legal counsels and accounting professionals early in the process to fully understand the issues and reach a decision that will produce the desired results.