

EBB Group of Texas

Stock vs. Asset sale

The purchase and sale of a business can be structured in either of two basic formats: 1) the purchase of the seller's stock, or 2) the purchase of the assets of the seller's business. From a tax perspective, the vast majority of buyers will prefer an asset sale, and the vast majority of sellers will prefer a stock sale. As a result, the asset vs. stock question most often creates conflict between buyer and seller.

Asset transactions

In an asset transaction, the assets to be acquired are specified in the contract. This process varies between industries, but in general, all the assets of the business excluding cash and accounts receivable and none of the liabilities are presented to the buyer. This allows the seller to use the proceeds from the sale to liquidate all short-term and long-term debts. Through this transaction, the buyer purchases all of the business's equipment, furniture, fixtures, inventory, trademarks, trade names, goodwill, and other intangible assets.

An asset transaction usually favors the buyer. The buyer acquires a new cost basis in the assets, which may allow a larger depreciation deduction to be taken. By setting higher values for assets that depreciate quickly, and lower values for assets that depreciate slowly or not at all, the buyer can derive tax benefits from the price paid, as depreciable assets can be written off in future years. The seller, on the other hand, must pay taxes on the difference between his basis in the assets and the price paid by the buyer for the business.

Example 1.1 shows a comparison of the tax consequences between an asset transaction and stock transaction.

When analyzing an asset transaction, you will see that the after-tax cost of an asset is its original cost basis minus the present value of depreciation or amortization deductions, taking into account the appropriate discount and tax rates.

With a stock transaction, the after-tax cost will equal the original cost basis. This results from stock not being depreciable. As seen in this example, a buyer is presented with a lower after-tax cost if he/she chooses to utilize the tax benefits of an asset transaction.

Example 1.1:

	Asset transaction	Stock transaction
Original cost basis	\$30,000	\$30,000
<u>-Depreciation</u>	<u>-\$8,200*</u>	<u>-\$0</u>

After-tax cost	\$21,800	\$30,000
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* Present Value of deduction depreciated over 20 quarters assuming a 9 percent discount rate and a 34 percent corporate tax rate

Also, the seller could be faced with a double taxation situation if the entity being sold is a C corporation. If this is the case, the seller would be taxed on both the appreciation of assets within the entity and the capital gains on the deemed sale of his or her stock. As shown in example 1.2, the seller or shareholder of a C corporation benefits from the sale of stock rather than assets from a strictly tax perspective.

Example 1.2:

	Asset transaction	Stock transaction
Sales price	\$4,000,000	\$4,000,000
Seller's basis	<u>-\$2,000,000*</u>	<u>-\$1,000,000**</u>
Capital gains from sale	\$2,000,000	\$3,000,000
Tax (34 percent)	<u>\$680,000</u>	<u>\$0***</u>
After-tax gain from sale	\$3,332,000****	\$3,000,000
Corporate tax (20 percent)	<u>\$664,000</u>	<u>\$600,000</u>
Realized gains from sale	\$2,656,000	\$3,400,000

* Corporations basis in assets

** Basis in total shares

*** Tax only applicable to stock at liquidation

**** Subtracted from sales price (4,000,000-680,000)

The buyer may also prefer an asset transaction for liability reasons. By purchasing assets, the buyer avoids the risk of becoming liable for any of the selling corporation's undisclosed or unknown liabilities. These unknown liabilities could include federal and state income taxes, payroll withholding taxes and legal actions.

Stock transactions

Stock transactions usually call for all of the assets and liabilities of the seller's corporation and the stock of the corporation to be transferred to the buyer. In some cases, the buyer and seller may choose to exclude certain assets or liabilities from being conveyed (such as real estate). In a stock transaction, the seller is conferred the tax liability. This results from the seller having to pay taxes on the difference between the seller's basis in the stock and the price paid by the buyer for the stock.

Most often, stock transactions are beneficial to both parties. Stock transactions provide for succession in relationships with suppliers. They also eliminate the necessity of

obtaining a new lease assignment when the lease is held only in the name of the corporation and when there is no stipulation in the lease calling for an assignment in the event of a change in the controlling interest of the corporation.

A risk faced by the buyer in a stock transaction would include acquiring unknown or undisclosed debts held by the designated corporation. By providing for the right of offset to future payments due the seller, the buyer can eliminate the risk of obtaining any undisclosed debts. In choosing to structure a deal as a stock transaction, the seller should be aware that the sale of stock in a closely held corporation falls under the umbrella of federal securities laws. This places a greater burden on the seller in a stock transaction to fully disclose all material information about the company. Failure to do so exposes the seller to the risk of securities fraud litigation (which reinforces the notion to seek legal council, as previously discussed).

Installment sales

It is rare for a privately held business to change hands for an all-cash price. The installment method is used when you receive at least one payment for your business after the year of sale. This provides for the seller to receive some cash, but for the bulk of the purchase price to be owner financed. For smaller, privately held businesses, the down payment often ranges from 10 percent to 40 percent of the selling price and the buyer executes a promissory note for the balance. The assets of the business typically secure this promissory note. Such notes are commonly instituted for a period of 3 to 15 years at an interest rate that varies with the prime rate, which is historically between 9 percent and 12 percent.

Leveraged buyouts

Identical to an installment sale, a leveraged buyout uses the assets of the business to collateralize a loan to buy a business. The difference being that in a leveraged buyout a buyer typically invests little or no money and the loan is obtained through an outside lender.

This type of purchase is best suited to asset-rich businesses so it's rarely used in wholesale distribution businesses unless there is a heavy real-asset bent to the acquisition. A business that lacks the assets needed for a completely leveraged buyout may be able to put together a partially leveraged buyout.

When leveraging the purchase or sale of a business, the seller finances part of the transaction and is secured by a second lien security interest in the assets. Due to the heavy debt burden placed on a company engaged in a leveraged buyout, the buyer and seller must look closely at the company's ability to service the debt. Looking at the future cash flows and income estimates of the business, as discussed in the previous article, can aid you in this process.

Earn-outs

Where there is a disagreement about how much the company is worth, it is fairly common to include an earn-out as one of the terms of the deal. An earn-out is a method of paying for a business that helps bridge the gap between the positions of the buyer and seller with respect to price. An earn-out can be calculated as a percentage of sales, gross profit, net profit or other figure. Typically, net sales are not used in this calculation because sales can easily be manipulated through distortion of expenses. It is not uncommon to establish a floor or ceiling for the earn-out.

Earn-outs do not preclude the payment of a portion of the purchase price in cash or installment notes. Rather, they are normally paid in addition to other forms of payment. From a buyer's perspective, an earn-out is a good solution to uncertainty about the business's future since the payments can often be internally financed. The buyer will want to place a cap on the total earn-out payments to limit the risks. Particularly if the seller remains active with the business, the buyer will want to be sure the seller is not making lots of sales that will never be collected on or that could potentially harm profit margins.

Stock exchanges

In some situations a business owner may want to accept the stock of a purchasing corporation in payment for the business. Typically, the stock he receives (if it is the stock of a publicly held company) may not be resold for two years. If the stock may not be freely traded, it is not as valuable as freely traded stock, and its value should be discounted to allow for this lack of market ability.

However, there is an advantage to the seller in this kind of transaction. Taxes incurred by the seller on the gain from the sale of the business are deferred until the acquired stock is eventually sold. This kind of transaction is termed a tax-free exchange by the IRS. There are several tests that must be met to qualify for this tax treatment. Check with a competent accountant or tax attorney prior to engaging in a transaction of this type. We will address this issue in more detail with a slightly different spin but one we think is viable and getting more attractive in article 10.

In summary, developing a proper transaction structure for the sale of your business requires more than just one individual decision. Finding the proper structure involves you and the buyer of your business to jointly determine the proper fit for your unique transaction. This entails knowing the proper tax consequences for each transaction option and knowing the pay structure each follows. Both you and the seller alike are conferred different circumstances regarding the previously mentioned structure options. And with the proper examination of each structure by both sides of the transaction along with your respective legal and accounting consultants, a suitable position can be obtained.

When deciding to sell your business, it is important to select the structure that fits your unique situation. To aid you in this process we have developed a frequently-asked-question sheet that provides a brief synopsis of each of the transaction structures. This should allow you to advance the transaction and further develop an idea of what direction you are headed. Just send us an e-mail request and we will forward it straightaway. In the next installment of our series, we will focus on the negotiation and closing of your sale transaction.

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