Choices in Selling a Business

By Jacob A. Chodash

Gene has run a successful company in the packaging industry for many years, but now has decided to sell. He's highly skilled in operating the company, but has never sold a business before in his life. He's come to me, uncertain as to where even to start thinking about how this can be done.

One place to start is to consider the three basic legal structures for selling a business: sell assets, sell stock, or do a tax-free merger. This article assumes that the legal form for your business is a corporation, and that you are a C-corporation for tax purposes.

The first and most popular structure is to sell your assets. This means that you transfer the existing physical assets and intangible assets to your buyer at closing by a bill of sale and assignment agreement. Physical assets include your inventory, machinery, equipment, supplies, furniture, fixtures, real estate, records, and so on. Intangible assets include your business name, phone and fax numbers, website, patents, trademarks, copyrights, and so on. Accounts receivable may or may not be transferred, and other assets (such as personal automobiles held by the business) may be kept in your corporation. It's important to recognize that in a sale of assets, you're keep your existing corporation alive, and you continue to hold your stock in the corporation.

Asset sales are the most popular because buyers like them - for two reasons. First, a buyer purchasing your assets takes the assets only, and not your liabilities. Your liabilities remain with your corporation, unless your buyer specifically agrees to assume them. Buyers can become concerned with liabilities such as taxes, environmental problems, or personal injury claims. There are a few exceptions to this general rule, so it is always best to consult your lawyer about your special situation.

The second reason buyers prefer asset sales is that buyers receive a better tax result. If a buyer purchases your assets, the buyer can establish a new tax basis for the assets by spreading the purchase price among the assets up to their fair market value, with any excess going to an account called "goodwill". If you have been depreciating your assets for tax purposes at the maximum rates provided by the Internal Revenue Code, then the tax basis of your assets in your corporation will probably be much less than their fair market value, and may even be $0 in some cases.

Your buyer likes the higher tax basis because a higher tax basis means bigger depreciation deductions, and bigger deductions means lower taxes. Even the excess purchase price allocated to the goodwill account can be amortized over 15 years, so all or much of the purchase price can be written off.

While buyers prefer assets sales, sellers prefer stock sales. By stock sales, I mean a sale of your shares of corporate stock in your company, not sale of inventory stock. In a stock sale, you sign over your corporate stock to the buyer at closing. Your corporation continues to exist, but is now owned by the buyer.

Sellers prefer sales of stock for the converse reasons that buyers prefer sales of assets. In a stock sale, all of the liabilities of the corporation remain in the corporation and are transferred with the stock to the buyer. You, as seller, no longer have to be concerned with them.

A stock sale also has a favorable tax result for the seller. The seller is taxed once on the transaction as a capital gain – your sales price less your tax basis in your stock (usually your cost) equals the capital gain you must report, which is taxed at a maximum federal rate of 20%, and also usually taxed under your state income tax. Contrast that with the tax impact on a seller of a sale of assets.

A seller is usually taxed twice on a sale of assets, and at higher rates. First, the corporation in taxed on the capital gain on the sale of assets (sales price less depreciated tax basis equals capital gain), at federal rates up to 21%, plus your state income tax rate. When your corporation liquidates and distributes the remaining purchase price to you, a second shareholder level tax is imposed on the capital gain you realize (the amount of the liquidating distribution less your tax basis in your stock equals your capital gain) at a maximum federal rate of 20%, plus your state income tax rate. As you might imagine, sellers generally pay a lot less in tax with a stock sale than an assets sale.

How is this conflict between the interests of the buyer and the seller worked out? There are several patterns which repeat.

If your attorney or accountant were far-thinking enough to recommend that you elect S-corporation status at the appropriate time, then your problems are solved. S-corporation (for "small" corporation) status means that you made a special election under federal tax laws that permits the income from your corporation to be taxed once, at the shareholder level. S-corporations generally pay no federal tax. This means that you can sell your business by selling assets (just as your buyer wants), and pay only one tax.

Like everything else in tax law, there are important exceptions. To get this favorable tax treatment, your S-corporation election must have been made at least 10 years ago, or if your corporation has not been in business for 10 years, then made in the tax year when your corporation started business. If you have been operating as a regular C-corporation for many years, the IRS has special rules which prevent you from getting single-tax treatment when you sell your assets, even if you now elect S-corporation status.

Let's suppose this special rule applies to your C-corporation, and you can't get single-tax treatment even if you now elect S-corporation status. What do you do? One common solution is to still agree to sell your assets, but to structure the deal in a way that keeps your tax low.

Assets are sold at or just above your corporation's tax basis in them. Since sales price equals tax basis, your corporation reports none or little capital gain and pays no or little tax. If you intended on staying on for a while to help the buyer during the transition period, a good part of the buyer's total payments can be made to you as wages as an employee or consultant. These wages are subject to a single tax, but the federal tax rate on them can be as high as 37%. Finally, any remaining payments from the buyer can be allocated to a non-competition agreement, which your buyer will probably ask for anyway. Payments under a non-competition agreement are taxed just like wages.

From the buyer's point of view, wages paid to an employee or consultant are immediately deductible, so your buyer will want to allocate a good part of the total payments to them. There is a limit, however; if the wages exceed what would be "reasonable compensation" for the actual services you perform, the IRS will re-allocate the excess wages to a goodwill account, deductible by the buyer over 15 years. Payments under a non-competition agreement are treated like goodwill, and likewise deductible by the buyer over 15 years. Allocation of payments to goodwill is not the best tax result for your buyer, but at least the buyer can get a deduction for them, albeit over 15 years.

The third basic way to sell a business is a tax-free merger. In this form, you don't get all cash or property for your business, but instead receive stock in the merged business now controlled by the buyer. Since you don't receive all cash or property, the transaction can be structured so that you don't pay any tax on the stock you get. This is a great result, but remember you gave your business away for a piece of paper (a stock certificate) which you can't spend like real money.

The IRS will catch up with you, though, when you try to sell your new stock, because the new stock takes a tax basis equal to your tax basis in the stock you gave up. So all of your capital gain will be reportable and taxable when you sell your new stock. Still, the tax on that capital gain is deferred until you sell your new stock, and if you die while still holding the new stock, the beneficiaries of your estate may escape paying tax on the capital gain entirely. I don't suggest you die in order to save taxes; even a tax lawyer has his limits.

Tax-free mergers are often used when the buyer is a publicly-held company. The buyer can acquire a business by merely issuing new shares of stock, and you as the seller get stock which you can readily sell in a public market. The rules concerning tax-free mergers are among the most complex in tax law, so make certain your lawyer and accountant are up to the task.

Jacob A. Chodash is a principal at the Chicago law firm of Eckhart Chodash & Strohmeier LLC. The examples in this article represent an aggregate of experiences from several persons. See a lawyer before you take any action involving a legal matter. Jacob can be reached at jchodash@eckhart.com.