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BUYING OR SELLING A BUSINESS

TAX ISSUES ON STOCK OR ASSET PURCHASE

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This paper explains the different tax consequences between two deal structures—a stock purchase and an asset purchase.

Tax on Gains

In an asset deal, the selling corporation sells its assets to the buyer and pays taxes on any gains, basically the difference between the cash received from the sale of assets and its tax basis in the assets. When the corporation distributes the cash from the sale of assets to its shareholders, the shareholders will have to pay taxes on the receipt of the cash. Thus, there is double taxation, which reduces the amount of money received by the shareholders.

In a stock deal, the selling shareholders pay taxes on any gains, which is the difference between the cash received from the sale and the tax basis in the shares. There is no tax paid by the corporation since it is not selling anything.

Tax Basis in Assets

In a stock deal, the buyer acquires the corporation and "inherits" the corporation's tax basis in its assets. For example, if the buyer pays $500,000 to the shareholders for their stock, and the corporation owns assets with a tax basis of $300,000, the corporation's tax basis in the assets will remain $300,000 after the deal closes.

In an asset deal, the buyer gets a stepped-up basis in the assets equal to the fair market value ("FMV") of the assets. Therefore, if the assets have a FMV of $500,000, the buyer's tax basis in the assets will be $500,000.

The difference in tax basis is important when the buyer later sells the assets. In a stock purchase, the corporation retains ownership of the assets. If the corporation later sells the assets for $600,000, the corporation will have to pay taxes on gain of $300,000 ($600,000 less its original tax basis of $300,000). (In certain circumstances, a buyer may be able to make an election under Section 338 of the Internal Revenue Code to treat a stock purchase as an asset purchase for tax purposes.)

In an asset purchase, the buyer acquires the assets and if it later sells the assets for $600,000, it will have to pay taxes on a gain of only $100,000 ($600,000 less the buyer's stepped-up tax basis in the assets of $500,000).

Conclusion

Obviously, there are significant and different tax consequences between an asset deal and a stock deal, which may affect the purchase price. A buyer and a seller of a business should discuss deal structure with legal counsel before engaging in discussions to buy or sell a business.

For more information on the tax consequences of a stock deal versus an asset deal, or on buying or selling a business, please contact Franco at gpietrafesa@archerlaw.com or 201-498-8559.

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