Implications of an asset based sale versus a stock based sale

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During an asset based acquisition, a buyer acquires those of a seller's assets and liabilities that are specified in the contract. Non-operating assets & liabilities (such as excess cash and debt) are usually not included. The seller keeps the "legal shell", including all legal liabilities.

From a tax point of view, an asset transaction generally favors the buyer since it allows him to set higher values for assets that depreciate quickly, and lower values for assets that depreciate slowly or not at all. The buyer acquires a new cost basis in the assets which may allow a larger depreciation deduction to be taken. However, it is important to keep in mind that the IRS pays attention to the question of whether the purchase price allocation is reasonable and treated consistently by both the buyer and the seller.

Most transactions (> 90%) between smaller privately held companies are asset transactions since the size of the transaction does not allow for the kind of due diligence budget required for a stock acquisition to be feasible. However, the risk of inheriting undisclosed debt or other liabilities of the seller in a stock transaction can be minimized by providing for the right of offset to future payments due to the seller. Also, an asset based transaction might be the only choice if there are minority shareholders who refuse to sell their shares. Shareholders own equity in a company but not in its individual assets which means that minority shareholders have limited options to prevent the sale of company assets if a sale is decided by a majority of shareholders. (Just like a minority shareholder in a public company like e.g. GE cannot prevent GE from selling major assets such as plants, intellectual property etc.). However, minority shareholders would be eligible to receive "fair value" compensation for their shares under such a scenario. "Fair value" usually exceeds "fair market value" since a "minority discount" is applied to a minority ownership interest in order to calculate "fair market value". An assets based transaction requires more preparation time for ownership transfer as most existing contracts etc. (payroll, insurances, leases etc.) have to either be individually reassigned to the new owner or renegotiated.

In a stock transaction/acquisition, the "legal shell" of the selling company is being transferred to the buyer including all assets and liabilities. Stock deals make the actual transfer of ownership (day-to-day management) easier for the buyer since usually all existing contracts (leases, payroll, employee benefit plans etc.) are transferred to the new owner. This is why companies which require special licenses to be operated, for example medical laboratories, often require a stock sale in order for those licenses to transfer to the new owners.

The seller must pay taxes on the difference between the seller's basis in the stock and the price paid by the buyer for the stock but a stock transaction nonetheless offers tax advantages to the sellers (the extent depends on many factors including the legal structure of the selling company: C-Corp versus S-Corp or LLC).

It is important to keep in mind that the sale of the stock of a closely held corporation falls under the umbrella of federal securities laws. Failure by the seller to fully disclose all material information about the business exposes the seller to the risk of securities fraud litigation.

Sole proprietorships and most LLCs or partnerships will be selling the assets of the company since they are not incorporated and there is therefore no stock to sell. Owners of S-Corporations can choose to sell either the assets or the stock of the corporation. Because S-Corporations are so called "tax flow through entities" (their income flows through to the stockholders), stock and asset sales normally yield similar taxation unless the S-Corp used to be a C-Corp and switched to S-Corp status within the last 7 years. Owners of C-Corporations should try to sell the stock of the company as opposed to the assets since this brings distinct tax advantages to the seller. Under an asset based transaction, the seller could be faced with a double taxation situation if the entity being sold is a C corporation: first the corporation (seller) will have to pay tax on the sale, then owner/seller will personally pay tax again on the after-tax amount that is being removed from the corporation. Since most buyers of smaller company will insist on structuring the acquisition as asset based, it is advisable for any seller, to run such companies as S-Corporations, as opposed to C-Corporations.

Potential tax implications for a C-Corp from a seller's perspective (example)

	Asset Sale	**Stock Sale**
Sale Price	6,000,000	6,000,000
Seller's basis for taxation	3,500,000	3,000,000
Capital gains from sale	2,500,000	3,000,000
Ordinary Income Tax at corporate level (graduated rates up to 35%)	840,600	0
Basis for taxation at shareholder level	5,159,400	6,000,000
Individual tax at shareholder level (15%; assuming either LT cap gain treatment or qualified dividend treatment)	773,910	900,000
Realized gains from transaction	4,385,490	5,100,000

Note: assumed tax rates are based on 2008 tax rates