TAX CONSEQUENCES OF SELLING YOUR BUSINESS

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So you've operated the business for several years, sales are at record levels, and you're starting to think about an exit strategy. You've been approached by a potential buyer for the business, and there's been some discussion about an asset sale vs. a stock sale. This article explains some of the important differences between these two sales structures.

Sale of Assets

In an asset sale (as the name implies), the owner of the business sells the business' assets. Although the parties typically negotiate a single sales price for the business as a going concern, in reality, the seller is selling the individual assets of the business, including business goodwill. This means, from a transactional perspective, that at closing, each individual asset must be transferred to the buyer. Title to personal property (including goodwill) typically transfers via delivery of a bill of sale; rights and obligations under real estate leases and other contract transfer by assignment. Business and other licenses sometimes transfer by assignment, or sometimes must be applied for by the buyer.

An asset purchase agreement typically identifies the assets and liabilities being transferred, and may also identify specifically excluded assets and liabilities.

If the sale involves goodwill or going concern value, IRC §1060 requires both the seller and the buyer to file Form 8594 (Asset Acquisition Statement), dividing the purchase among the following seven "classes" of assets: Class I assets (cash and general deposit accounts), Class II assets (actively traded personal property, including certificates of deposit and foreign currency), Class III assets (certain types of debt instruments), Class IV assets (inventory, stock in trade), Class V assets (all other assets, including furniture and fixtures, buildings, land, vehicles, and equipment, which constitute all or part of a trade in business), Class VI assets (all section 197 intangibles (such as value attributed to having a workforce in place, business books and records, operating systems, know-how, licenses, permits, etc.) except goodwill and going concern value, and Class VII assets (goodwill and going concern value).

The purchase agreement should reflect the allocation or at least a method for computing the allocation (you may consider attaching a completed Form 8594 to the purchase agreement). As the seller, you will recognize gain to the extent that the allocated portion of the purchase price exceeds your tax basis in the asset, and you will recognize loss to the extent that your tax basis exceeds the allocated portion of the purchase price.

By way of example, let's assume that you own a hair salon business that you agree to sell for $100,000, divided as follows: $5,000 for Class IV assets (inventory of hair care products held for retail sale), $30,000 for Class V assets (leasehold improvements and a chair), and $65,000 for Class VII assets (goodwill and going concern value).

The following chart represents acquisition cost, tax basis (after depreciation), and fair market value for these items:

Property	Acquisition Cost	Tax Basis	Fair Market Value
Inventory	$5,000	$5,000	$5,000
Leasehold Improvements	$25,000	$10,000	$25,000
Chair	$10,000	$0	$5,000

You will recognize $0 in gain on the sale of the inventory, $15,000 in gain on the sale of the leasehold improvements, and $5,000 in gain on the sale of the chair. The next step is determine whether the gain will be characterized as capital gain or ordinary income.

The character of gain or loss to the seller is determined by reference to the asset sold. Under IRC §1231, gain recognized on the sale or exchange of depreciable property used in a trade or business held for more than one year, and real property used in the trade or business held for more than one year (referred to sometimes as §1231 property), is treated as long term capital gain. Section 1231 property specifically excludes inventory or property held primarily for sale to customers, copyrights, and rights in literary, musical, or artistic compositions.

Therefore, gain from the sale of most assets used in a trade or business (including goodwill) will be subject to capital gains rates, with two important exceptions: (1) gain from the sale of certain income-producing assets (e.g., inventory, accounts receivable, etc.) will be treated as ordinary income, and (2) gain realized on the sale of depreciated property will be treated as ordinary income up to the amount of depreciation deductions taken (or, in the case of real property, up to the amount that actual depreciation deductions exceed the amount of allowable deductions using the straight-line depreciation method, sometimes referred to as “additional depreciation”).

So back to our example above, if you purchased a chair for $10,000 and took depreciation deductions of $10,000, you would have a tax basis in the property of $0. If you then sold it for $5,000 (representing the fair market value at the time of the sale), you would recognize ordinary income of $5,000.

The character of the gain or loss is determined by reference to the assets in the hands of the selling entity, and flows through to the owners. In a partnership, gain or loss is allocated among the partners according to the partnership documents, subject to §704(c) rules, which requires that, to the extent that any property contributed by a partner to the partnership had any built-in gain or loss at the time of the contribution (i.e., if the fair market value of the property differed from the partner’s tax basis in the property at the time of the contribution) the amount of the built-in gain or loss must be allocated back to the contributing partner when the property is sold. In an S corporation, gain or loss is allocated among the shareholders according to their pro rata share of ownership in the corporation.

In an asset sale, the buyer acquires a cost basis in each asset purchased. The buyer also may take allowable depreciation deductions going forward, which makes an asset sale attractive to a potential buyer.

Sale of a Partnership Interest

So what if the partners sell their interests in a third party sale?

The collective sale of partnership interests to an unrelated buyer produces tax results similar to an asset sale. Generally speaking, the sale of partner’s interest in a partnership is considered the sale of a capital asset. IRC §751, however, provides that the portion of the sales price attributable to the partner’s interest in (1) unrealized receivables of the partnership, or (2) inventory items of the partnership (sometimes referred to as “hot assets”) be taxed as ordinary income. Unrealized receivables include accounts receivable and other contractual rights to receive payment for goods delivered or services rendered, depreciation recapture under IRC §§1245 and 1250 (as described above), and other types of sales.

The practical effect is that §751 requires a selling partner to recognize, as ordinary income, gain on the sale of hot assets, including depreciation recapture. From this perspective, there is little tax difference between a partnership’s sales of assets and the sale of individual partnership interests.

From the buyer’s perspective, whenever an unrelated buyer acquires all outstanding partnership interests, there is a deemed liquidation of the partnership. The partnership is deemed to make a liquidating distribution of its assets to the original partners and is deemed to have acquired, by purchase, all of the former partnership’s assets. The buyer’s basis in the assets is the purchase price paid by the buyer, and the buyer’s holding period for the assets begins on the day immediately following the date of sale. In most cases involving a third party sale, therefore, there is no significant tax difference to the buyer whether the sale of the partnership’s business is viewed as the sale of assets or the sale of the various partnership interests.

Sale of Stock in an S Corporation

Generally speaking, the sale of an interest in an entity taxed as an S corporation is treated as the sale of a capital asset. Unlike the sale of a partnership interest, no special treatment attaches to the portion of the sale attributable to accounts receivable or other income-producing assets (i.e., the concept of "hot assets" doesn't exist in a stock sale). For these reasons, a stock sale typically is more attractive to the seller of a business.

Because a stock sale does not trigger the depreciation recapture rules of IRC §§1245 or 1250, the corporation retains its depreciated tax basis in the assets and, therefore, there typically is little opportunity for taking future depreciation deductions. For this reason (as well as liability reasons), a stock sale typically is less attractive to a potential buyer.

Conclusion

Ultimately, the tax consequences of selling a business depend on a variety of factors, including the nature and profitability of the business, the type of assets that it holds, the tax classification of the business, and your tax basis in the entity. Because the tax consequences can significantly affect the amount of money that remains in your pocket, it is strongly recommended that you consult with your CPA or tax advisor before agreeing on a sales price.

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