Tax issues to consider when buying or selling a business

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If you're buying or selling a closely held business, there's a wide range of business, legal and financial issues to consider. Although a sale's terms should never be driven by tax considerations alone, taxes can have a significant impact. Following are some of the issues you should consider.

Stock vs. assets

If the business being sold is a corporation, the parties can structure the deal as a stock sale or an asset sale. As a general rule, sellers prefer to sell stock, while buyers prefer to buy assets.

Sellers like to sell stock because the shareholders' profits on the sale are generally taxed as capital gains (usually at the favorable long-term rate). Profits from asset sales, on the other hand, are typically taxed as a combination of ordinary income and capital gains.

Also, an asset sale will cause C corporation sellers to be taxed twice: First, the corporation pays tax on any gains from the asset sale; then, the corporation's shareholders pay tax on their gains when the corporation is liquidated (although it may be possible to defer the second tax by having the corporation hold and invest the sale proceeds).

Double taxation generally isn't a concern for an S corporation, unless it was originally organized as a C corporation and later elected S status. In that case, depending on how much time has passed, there may be a double tax on assets that had built-in gains at the time of the S election.

From the buyer's perspective, purchasing assets is usually more desirable because its basis in assets for depreciation purposes is generally equal to the portion of the purchase price allocated to those assets, typically allowing for greater depreciation deductions. If the buyer purchases stock, it assumes the seller's basis in the corporation's assets, which may already have been depreciated down to a small amount, or even zero, thereby providing little or no tax benefit for the buyer.

Purchase price allocation

In an asset sale, the tax implications - for both buyer and seller - depend on how the purchase price is allocated among various assets. The catch is that the buyer and seller must use the same allocation for tax purposes, yet they often have conflicting interests. The parties have some leeway to negotiate the allocation, but the IRS may find the allocation to be unreasonable or bear little correlation to asset values and challenge it.

The seller will want to allocate as much of the purchase price as possible to assets that generate lower-taxed long-term capital gains, such as goodwill or real property. This allocation is less desirable for the buyer, though: Goodwill and certain other intangibles are amortized over 15 years, and real property is depreciated over several decades.

Buyers generally prefer to allocate as much of the purchase price as possible to assets that can be depreciated quickly, such as equipment, computers and vehicles. This poses a problem for sellers, however, because often these assets are fully depreciated, and "recapture" of previous depreciation deductions is taxed at ordinary income rates.

Weigh your options

By understanding how taxes affect the economics of a deal, you can adjust the purchase price or terms accordingly. For example, if a deal structure favors the buyer from a tax perspective, the parties might increase the purchase price to compensate the seller for its disadvantaged tax position. Be sure to also consult with an attorney regarding the potential legal liability differences between an asset and stock purchase.

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