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Key Tax Considerations When Selling a Business

Stock Versus Asset Deals

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For many business owners, selling a business is the culmination of a lifetime of work building the business. It's also often a once-in-a-lifetime experience. Thus, knowing how much money they will have after the sale is of the utmost importance. The answer relies, in large part, on how the sale will be taxed, which is rarely straightforward. This introduction to the key issues that drive tax obligations is vital for every business owner considering the sale of a business.

Stock Deals Versus Asset Deals

The first step in understanding how a transaction will be taxed is identifying what is being sold. Is it the owner's stock, membership units in an LLC, interests in a partnership or the actual assets of the business? Most sellers assume they are selling their stock, resulting in a capital gain that is taxable at the state level in their home state. It's a bit more complicated when selling units in an entity treated as a partnership for tax purposes (more on that below).

Most buyers, however, do not want to purchase stock and prefer an asset-based transaction. That's because an asset deal produces valuable benefits for buyers through depreciation and amortization deductions for future taxes. Furthermore, an asset deal generally allows buyers to be more isolated from any business liabilities that may have arisen prior to purchase.

This difference between a stock deal and an asset deal significantly impacts how the transaction is taxed. As the business's assets are sold individually, some may generate ordinary income instead of a capital gain. For state tax purposes, that income is attributed to the business – not the owner. As a result, the state tax may change in both positive and negative ways for the seller.

It's important to note that not all asset sales involve the direct purchase of a business's assets. In some cases – such as a "338 transaction" (named for the Internal Revenue Code section that covers it) or F reorganization – a transaction may be structured as a stock sale legally but treated as an asset sale for tax purposes.

PKF O'Connor Davies Observation: In the early stages of a transaction, it is not always clear whether a transaction will be a stock or an asset deal. There can be clues in a letter of intent; for example, a statement that the transaction will be structured to achieve a step-up in asset basis indicates that the buyer is looking for an asset deal. If the transaction structure will significantly impact the seller's tax obligations, however, this should be discussed as early as possible.

"Hot" Assets

As noted above, one of the key differences in an asset sale is that the tax on any capital gain must be assessed asset-by-asset. This affects each business differently and depends on whether assets sold produce a capital gain or would be taxed as ordinary income. The latter are a business's so-called "hot assets." It is also important to note whether the business is a C Corporation or a pass-through entity (S Corporation or partnership). This article focuses on the taxation of pass-through entities (learn more about the taxation of C Corporation shareholders in stock and asset deals). Note that for owners of a partnership interest, a stock sale also requires factoring in tax on hot assets, making this issue key even when a buyer is willing to purchase partnership interests or membership units.

The concern around "ordinary income" is that it's taxed at higher rates than capital gains. For owners of a pass-through entity, capital gains cap out at a tax rate of 20% for owners who actively participate in the business, while ordinary income can be taxed up to 37%.

PKF O'Connor Davies Observation: It's essential to review sellers' specific situations to understand their personal tax rate, which can vary based on the amount of ordinary income, the application of the qualified business income deduction and any other income on their personal return.

In an asset sale, value is assigned to each asset being purchased. Read more about purchase price allocations in asset sales. Many assets will still generate capital gain (the primary one often being goodwill). But two assets in particular can impact a seller's overall tax on the transaction:

- Accounts Receivable: Cash basis taxpayers will generally need to pay ordinary income tax on their accounts receivable at the time of the transaction – this mimics how these receivables would have been taxed when paid. On the flip side, this is not an issue for accrual basis taxpayers, who will not have a gain on the sale of receivables (since they have already paid tax when accrued).

- Fixed Assets: Many businesses have a fixed asset basis of close to zero due to bonus depreciation, which has been available since the Tax Cuts and Jobs Act of 2017 (TCJA). Thus, any value allocated in the purchase price allocation would generate ordinary income for the seller because of depreciation recapture. This is generally not an issue for businesses with few fixed assets.

For the seller preparing to sell a business, it's essential to understand the difference between a stock sale and an asset sale – and how significant the impact of that difference will be. A cash-basis business heavy on fixed assets (e.g., a construction business) will be in a very different position than an accrual-basis business with little to no fixed assets (e.g., a consulting firm).

Consideration	Stock Deal	Asset Deal
Seller's tax rate	Capital gains (up to 20%)	Capital gain & ordinary income (up to 37%)
Buyer's preference	Less preferred by buyers	Preferred by buyers
Liability assumption	Buyer assumes more liability	Liabilities generally excluded
Depreciation benefit	No step-up in asset basis	Step-up in asset basis; future deductions
State tax location	Taxed where seller resides	Taxed where business operates
Complexity of allocation	Low	High (requires asset-by-asset allocation)
Common in practice	Preferred by sellers	Preferred by buyers

State and Local Taxes

A stock sale is generally taxed in the state where its seller resides. Owners living in New York, for example, pay New York tax. On the other hand, owners living in Florida pay no state tax. An asset sale, however, is taxed where the business pays tax, typically the state in which it operates and serves its customers. Partnership sales also follow the asset sale treatment in certain states.

This can be an important concern for business owners. An owner may reside in Florida but own a business that operates and pays tax in New York, meaning the difference between a stock and asset sale could be significant – perhaps even worse if the business is in New York City. Some businesses will allocate their income to many states, making analyzing the tax on an asset sale more complex.

The impact is different for each business. For those who live in Connecticut and own a business located entirely in Connecticut, the difference between a stock and an asset sale for a pass-through business is likely to be minimal at the state level.

The Pass-Through Entity Tax Flip

In certain circumstances, a business owner will be better off with an asset sale than a stock sale. This usually relates to the benefits of state pass-through entity tax.

The TCJA capped state and local tax deductions at $10,000, which created a greater burden on residents of states with higher tax rates. In turn, many states have enacted provisions allowing flow-through entities to choose to pay state taxes at the entity level, thereby generating a federal tax deduction that circumvents the $10,000 cap.

In the sale of a business, this can have a significant impact.

A business owner's ability to deduct hundreds of thousands, or even many millions of dollars, in state taxes can produce more after-tax dollars in an asset sale.

This is especially true when the asset sale is not otherwise generating significant additional tax (i.e., when there are few hot assets in the business and minimal extra state and local taxes due).

Conclusion

When selling a business, owners must be aware that deal structure can substantially affect how the transaction is taxed. Naturally, every situation is unique; thus, modeling is essential to understanding how significant this difference is – sometimes even providing the surprising result that the often-maligned asset sale is more advantageous for the seller.

Asset Type	Tax Treatment	Tax Rate Impact
Goodwill	Capital gain	Up to 20%
Accounts receivable (cash basis)	Ordinary income	Up to 37%
Accounts receivable (accrual basis)	No gain (already taxed)	N/A
Fixed assets (fully depreciated)	Ordinary income (depreciation recapture)	Up to 37%

Contact Us

Our team has advised sellers in a wide range of industries and in all types of transactions. If you'd like to discuss how we can help, please contact:

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