



FRED

Fast Resources for Enterprise Development



Wyoming Small Business
Development Center

Document # 357
April 2002

STRUCTURING THE BUY/SELL TRANSACTION

Description: *Comparison of asset versus stock transactions and financing options*

Structuring The Transaction

Tax and other consequences of the structure of a transaction have an important effect on the overall value of the transaction to the principals. Each type of structure carries with it different tax consequences for the buyer and seller.

*An asset transaction
generally favors
the buyer.*

The type of corporation owned by the seller (regular corporation or S corporation), the size and date of the transaction, and the type of consideration paid may all have a bearing on the tax consequences. Since tax law is constantly changing, it is important to seek legal and tax advice in determining the best way to structure the purchase or sale.

Asset Versus Stock Transactions

The purchase and sale of a business can be structured in either of two basic formats: (1) the purchase of the stock of the seller's corporation, or (2) the purchase of the assets of the seller's business.

Asset Transactions

In an asset transaction, the assets to be acquired are specified in the contract. Practices vary from industry to industry but, in general, all the assets of the business except cash and accounts receivable and none of the liabilities of the business convey to the buyer. The seller uses the proceeds from the sale to liquidate all short term and long term liabilities. This means that the buyer purchases all of the business's equipment, furniture, fixtures, inventory, trademarks, trade names, goodwill and other intangible assets.

An asset transaction generally favors the buyer. The buyer acquires a new cost basis in the assets, which may allow a larger depreciation deduction to be taken. The seller must pay taxes on the difference between his basis in the assets and the price paid by the buyer for the business. The buyer may also prefer an asset transaction for liability reasons. By purchasing assets, the buyer may avoid the possibility of becoming liable for any of the seller's corporation's undisclosed or unknown liabilities. The most common liabilities of this type are federal and state income taxes, payroll withholding taxes and legal actions.



Stock Transactions

Stock transactions generally call for all of the assets and liabilities of the seller's corporation and the stock of the corporation to be transferred to the buyer. In some cases, the buyer and seller may choose to exclude certain assets or liabilities from being conveyed. 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.

Sometimes stock deals are more expedient for both parties. Stock transactions provide for continuity in relationships with suppliers. They also preclude the necessity of obtaining a lease assignment when the lease is held only in the name of the corporation and when there is no provision in the lease calling for an assignment in the event of a change in the controlling interest of the corporation.

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.

The risk of inheriting undisclosed debts of the seller in a stock transaction can be minimized by providing for the right of offset to future payments due the seller or by the seller indemnifying the buyer. In choosing to structure a deal as a stock transaction, the seller should be aware that the U.S. Supreme Court has ruled that the sale of the stock of a closely held corporation falls under the umbrella of federal securities laws. This places a greater burden on the seller in a stock transaction to fully disclose all material information about the business. Failure to do so opens the seller up to the risk of securities fraud litigation.

Installment Sales

It is rare for a privately-held business to change hands for an all-cash price. Almost all transactions are structured as installment contracts which provide for the seller to receive some cash, but for the bulk of the purchase price to be owner financed. For smaller privately-held businesses, the down payment often ranges from 10%-40% of the selling price and the buyer executes a promissory note (secured by the assets of the business only) for the balance. Such notes are typically for a period of 3-15 years at an interest rate that varies with the prime rate but is most often 9-12%. The payments required to retire the debt service should not exceed 25-50% of the discretionary cash flow as calculated in the section on "Pricing the Business".

Leveraged Buyouts

Just as in an installment sale, a leveraged buyout uses the assets of the business to collateralize a loan to buy the business. The difference is that the buyer in a leveraged buyout typically invests little or no money, and the loan is obtained from a lending institution. This type of purchase is best suited to asset-rich businesses. A business that lacks the assets needed for completely leveraged buyout may be able to put together a partially leveraged buyout.

In this structure, the seller finances part of the transaction and is secured by

a second lien security interest in the assets. Because leveraged buyouts place a greater debt burden on the company than do other types of financing, buyer and seller must take a close look at the business's ability to service the debt.

Earn-Outs

An earn-out is a method of paying for a business that helps bridge the gap between the positions of the buyer and seller with respect to price. An earn-out can be calculated as a percentage of sales, gross profit, net profit or other figure. It is not uncommon to establish a floor or ceiling for the earn-out.

Earn-outs do not preclude the payment of a portion of the purchase price in cash or installment notes. Rather, they are normally paid in addition to other forms of payment. Because the payment of money to the seller under the provisions of the earn-out is predicated on the performance of the business, it is important that the seller continue to operate the business through the period of the earn-out.

Stock Exchanges

In some instances a business owner may want to accept the stock of a purchasing corporation in payment for the business. Typically, the stock he/she receives (if it is the stock of a publicly-held company) may not be resold for two years. If the stock may not be freely traded, it is not as valuable as freely traded stock, and its value should be discounted to allow for this lack of market ability.

There is an advantage to the seller in this kind of transaction. Taxes incurred by the seller on the gain from the sale of the business are deferred until the acquired stock is eventually sold. This kind of transaction is termed a tax-free exchange by the IRS. There are several tests that must be met to qualify for this tax treatment. Check with a competent accountant or tax attorney or request a ruling from the IRS Reorganization Branch in Washington, D.C.

It is important to have qualified legal and financial help when structuring the buy/sell transaction to maximize value for both the buyer and the seller.

Author: Arlene Soto, WSBDC Region 4

Source: U.S. Small Business Administration

This information is provided by:

Wyoming Small Business Development Center

P.O. Box 3922

Laramie, WY 82071

Phone Toll-Free: 1-800-348-5194

FRED toll-free number: 1-877-700-2220

SBDC website: www.uwyo.edu/sbdc

Taxes incurred by the seller on the gain from the sale of the business are deferred until the acquired stock is eventually sold. This kind of transaction is termed a tax-free exchange by the IRS.