

Stock versus Asset Sale & Estimated Purchase Price Allocation Consequences

Often Overlooked Aspects of a Small Business Sale

By Ryan Clark and Robert Rodriguez, CPA, The Veld Group



When it comes time to sell a business, one key item that Buyers and Sellers often overlook are the consequences of purchase price allocation. While the form a business sale takes, and the allocation of consideration value is a very straightforward topic, the tax impact of a stock versus asset sale, and allocation of purchase price within the seven categories of assets can have a significant impact on realized value to both the Buyer and the Seller.



Asset vs. Stock Sale

The first, and typically most confusing, consideration for small business Buyers and Sellers is whether or not the sale of a small business should be considered an asset sale or a stock sale. For the purposes of this article, we will consider a small business to be one that is under \$5 million in total consideration (sales price), and where 100% of the interests in the business are sold by and to either a single buyer and seller, partnership, or a non-public corporate entity with a single officer as the majority shareholder.

To dispel the first common misnomer, any small business sale, regardless of whether or not a buyer is purchasing a going concern (an open, ongoing business) or a non-concern, or whether or not the buyer intends to maintain the exact same concept, staff, vendors, lease, goodwill (name and additional intangible assets) or not, can be either an asset sale or stock sale. The primary point of differentiation is simply whether or not a buyer seeks to purchase the stock of a corporate entity that may hold the selling company's assets – assuming the selling company is an organization such as an S or C Corporation, or Limited Liability Company (which is a pre-requisite for a stock sale), or purchase the majority of the selling company's assets individually. If only a small portion of a company's assets are purchased, a sale may be a true 'asset sale', but such a sale is usually indicative of a sale of a minority portion of a distressed (or failed) company's hard assets at a dramatically reduced price or "liquidation" value.

The primary difference in the two types of small business sales has to do with the treatment of corporate liabilities (and oftentimes, the corporate entity's bank accounts, payables and receivables, cash, and deposits), which may transfer to the Buyer in a Stock sale (if specified, corporate liabilities can also transfer in an asset sale, or similarly not transfer in a stock sale).

The second main point of differentiation in the two types of sales has to do with the treatment of depreciation (for the Buyer), and the resultant capital gains impact (for the Seller). In a stock sale, the buyer essentially 'walks-into' the Selling entity's existing balance sheet - with the value of depreciated assets and accumulated depreciation remaining the same. In a stock sale, the Seller generally realizes all of the sales proceeds as

capital gains (at an approx. 15% Federal Tax rate), as opposed to having a portion of the proceeds being subject to ordinary income tax rates (typically between 28% and 35% Federal Tax Rates).

If a sale is an asset sale, the depreciation that a Seller has already realized is 'recaptured' at ordinary tax rates. That is, the Seller will pay ordinary, or regular income taxes on the portion of accumulated depreciation (depreciation already taken) that exists on the prior year's tax returns. The Buyer, on the other hand, is able to "step-up" the basis value of the assets to the current fair market value of the fixed assets. If this is to occur, both parties to the sale must agree upon this amount prior to the finalization of the sale (and sales taxes may need to be collected on a portion of those retail sales related assets, or on the sale of registered vehicles). To ensure both parties report the same asset allocation, the purchase price allocation should be included in any purchase contract, and the parties should each ensure that IRS Form 8594 is filed when the parties file their subsequent annual returns.

To clarify this in simplistic terms an example is provided. If a manufacturing company is sold that has \$1 ml in assets on the books, and \$500,000 in accumulated depreciation, in a stock sale the Seller would only pay capital gains taxes on 100% of the purchase price (less the basis value of the stock). In an asset sale under the same circumstances, the Seller would pay income taxes at ordinary federal income tax rates on the \$500,000 of indicated accumulated depreciation, and capital gains rates on the remaining portion of purchase price, assuming the business was held for more than a year.

The third unique item that comes into play in a stock sale versus in an asset sale has to do with the purchase price allocation, which is a specific categorization of the value of the assets being sold. Asset categories that appear in Asset Sales (but could also be applicable to a stock sale) typically include:

- Class I - Cash deposits,
- Class II - Liquid personal property (certificates of deposits, foreign currency, bonds, etc.),
- Class III - Accounts Receivable or other assets that are 'marked to market',
- Class IV - Inventory or trade stock,
- Class V - Fixed assets,
- Class VI - Intangible assets (including workforce-in place, business records, business licenses and permits, vendor relationships, franchise rights, trademarks, trade name),
- Class VII – Other goodwill and going concern value.

Factors typically unique to Stock Sales include the value of the stock, or the stock's stated par value. Specific allocation which may be seen in both types of sales include leasehold improvements, lease, non-compete agreements, training agreements, consulting agreements, training manuals or instruction, and specific licenses (liquor), building structures, land or vehicles included in the sale. The most updated classes of assets may be found under the Internal Revenue Service's Section 1060 list of asset allocation.

Finally, the most important consequence of delineating a sale as a "Stock" or "Asset" Sale is the impact of taxes paid by both parties, as well as the tax write-offs and depreciation or amortization benefits received by the Buyer. A convenient rule of thumb to realize in developing a cost / benefit analysis of different allocations is that what is typically economically beneficial for one party, is typically equally economically detrimental to the other party. The exception to this very general rule may be found in the treatment of 'restating' asset value subject to retail sales taxes – which will be further elaborated on below.

A few typical “Rules of Thumb” for the typical asset categories involved in a small business transaction may be found below.

Category	Seller	Buyer
Inventory	Ordinary Income Tax (if sold over basis value)	Recognized as a Cost of Goods when Sold
Fixed Assets / Leasehold Improvements / Registered Vehicles	Ordinary Income on assets that have already been depreciated (ref. Accumulated Depreciation); Capital Gains if a gain on sale is realized (and held more than 1 year)	Valued at Fair Market Value and Depreciated per IRS Schedule. Also Reference potential Section 179 Deductions on Fixed Assets.
Liquor, Beer, Wine License	Capital Gains if held for more than 1 year	Amortize according to IRS Schedule (typically 15 yrs)
Goodwill, Going Concern Value, Other Intangible Assets	Capital Gains if held for more than 1 year	Amortize according to IRS Schedule (typically 15 yrs). Reference Section 197 Intangibles on Class VI Identifiable Goodwill.
Buildings / Land	Ordinary Income on assets that have already been depreciated (ref. Accumulated Depreciation); Capital Gains if a gain on sale is realized (and held more than 1 year)	Depreciate buildings according to IRS Schedule; Land is not depreciated
Non Compete Agreement	Ordinary Income	Amortize according to IRS Schedule (typically 15 yrs)
Training / Consulting	Ordinary Income	Expense as paid
If a Stock sale		
Stock (solely in the Case of a Stock Sale)	Capital Gains if held for more than 1 year	Carryover / Continuation of Seller's Balance Sheet (i.e. Assets transfer at current book value)

Note: Federal Ordinary Income Taxes are 10% - 35% (28% for \$82k - \$171k in income), whereas Capital Gains are typically 15%. State taxes may also apply. In California, one may anticipate 1.0% to 10.3% in state income taxes (typically 9.3%) applicable to either ordinary income or capital gains tax.

In addition, restating fixed asset values are considered a potential exception to the cost / benefit rule given that sales taxes (at varying local rates) are often assessed on the sale of those items associated with retail sales (and potentially, with registered vehicles). It is often beneficial for Buyers to restate fixed asset values at higher rates than fair market values would suggest as doing so may represent an ‘arbitrage opportunity’ for

a Buyer. That is, the cost to the buyer may be retail sales taxes at local rates (e.g. 9.25% in California) which will be due on sale, however, the Buyer will subsequently be able to potentially depreciate those assets (oftentimes at accelerated rates) and save in paying future taxes at ordinary income rates on the same amount of income that the additional depreciation represents. The depreciation offset is then at ordinary income rates, so the Buyer essentially benefits by the amount of ordinary federal (and state) income taxes, less the amount of sales taxes initially incurred. Of course, when determining the full benefit of this approach the "time-value" of the Buyer's capital initially expended on sales taxes paid must be taken into consideration.

The above article is written for illustrative purposes only. A small business Buyer, Seller, Broker or other party associated with any small business sale should consult with a licensed tax professional that is familiar with the party's specific tax return, in addition to the Internal Revenue Service's current policies prior to making any decisions based on the content of this article. Further, the above examples do not necessarily include the impact of state taxes, any idiosyncrasies of the typical tax return (i.e. if it contains a tax loss carry forward, a Section 179 deduction, etc.), or allowance for the value of being 'cooperative' or negotiating in good faith with the other party in accomplishing a small business sale.

Ryan J. Clark



Ryan Clark, an entrepreneur, former world-class athlete, and likely California's top business broker, is the Director of Sales for The Veld Group. Mr. Clark attended The University of Nevada, Las Vegas (UNLV) where he received his Bachelor of Arts in Finance as well as being elected president of his fraternal organization. Always extremely driven and focused, Mr. Clark honed his sales skills while still in high school, and went on to perfect them while in college when he launched his own firm – R.C. Enterprises, a national direct sales company. After achieving substantial success and building a vast personal and business network, Mr. Clark merged his finance and sales background and joined Citigroup as a Senior Financial Planner for high net worth individuals. At Citigroup, Mr. Clark's services included corporate retirement planning, investment management, insurance and estate planning.

In the mid 1990's Mr. Clark accepted a long-term consulting engagement and relocated from Las Vegas to Southern California to establish the U.S. sales force for a multi-national sales organization. In this role Ryan implemented the business plan he authored and hired, trained and rolled out his sales strategy in the firm's five Southern California locations. In 1999, Mr. Clark rejoined his childhood friends and family and accepted a position as a Senior Vice President at Veld Consulting. In this role, Mr. Clark helped develop the firm's California sales strategy, hired and trained its sales staff, and transitioned its retainer based consulting pricing model to the needs of the California market. In 2002, Mr. Clark was then instrumental in launching The Veld Group's full-service Valuation and Business Brokerage division.

Within 3 short years of heading The Veld Group's Business Valuation, Business Brokerage, and Mergers and Acquisitions sales departments, Ryan Clark established himself as California's leading business broker. Regularly selling over 100 businesses per annum, Mr. Clark has managed to not only single-handedly outpace entire competing brokerage offices, but he has also managed to surpass the 'done-deals' transaction benchmarks set by California's most seasoned brokers who boast 30 plus years of industry experience.

Ever so humble for his accomplishments, Mr. Clark attributes his tremendous success to his strong support network which includes his wife and children, family, friends and support staff, his early entrepreneurial experiences, and to the discipline he developed as a former world-class track athlete, (while he would never boast of it, Mr. Clark is a former Division 1 collegiate sprinter who once held records in the 100 meter and 200 meter events). This discipline, coupled with the internal balance that he has developed from his daily yoga practice, has propelled him to the top of the business brokerage industry, where he suggests that "grace complements achievement".

Robert A. Rodriguez



Mr. Robert A. Rodriguez is a Certified Public Accountant (C.P.A.), as well as a licensed California Real Estate Broker with 14 years of experience selling, acquiring, merging and consulting businesses. Mr. Rodriguez received a Bachelor of Arts degree in Accounting from the University of San Diego (U.S.D.), where he was a key contributor to his fraternal organization's community outreach program. Mr. Rodriguez's career began as a mortgage loan officer at Wells Fargo Bank, where he implemented and managed their Spanish Loan Hotline, one of the first of its kind. Mr. Rodriguez left Wells Fargo to join Howard Publications, where he began his accounting career.

At Howard Publications, Mr. Rodriguez was regularly promoted until he became the firm's Assistant Controller. In this role Robert managed the financial reporting for 18 newspapers, 4 domestic natural gas trading divisions, and the Eastern European natural gas exploration division. During this time he also coordinated the acquisition of a \$25 million publishing subsidiary in Washington, led the forensic investigation of a \$1.2 billion natural gas trading operation (and, prior to the Enron scandal, discovered similarly fraudulent accounting practices), and consulted on various natural gas trading, transportation and exploration engagements in the U.S., Canada, Ukraine and Azerbaijan. Upon Howard Publications sale (for \$400 ml.), Mr. Rodriguez joined National Retail Partners where he managed a \$400 million commercial property portfolio for California Public Employment Retirement System – the largest public pension fund in the U.S. (CalPERS).

In 2002 Robert launched Integrity Valuations and Business Consulting ("Integrity") in San Diego, California. Integrity Valuations and Consulting specialized in providing small and mid-size businesses with accounting, tax, valuation and consulting studies related to growth strategies, tax planning, and the implementation of cost management and efficiency programs. Within months of implementation, Integrity managed the investment and financial divisions for some of San Diego's most successful restaurants and nightclubs including the Side Bar, Stingaree and Confidential Restaurant and Loft. Mr. Rodriguez was also responsible for the creation and management of a variety of syndicated investment groups, all of which raised capital for the acquisition of commercial and private investments. The accounting systems that Mr. Rodriguez created and implemented are still used by the Gaslamp's top restaurants and nightclubs.

In 2003, Robert Rodriguez merged Integrity Valuation with The Veld Group's Valuation and Consulting division, which provided business appraisals for divorce, income tax, estate and buy and sell agreements, and helped business owners prepare for the sale of their companies. Upon taking the division over, Mr. Rodriguez developed the department and expanded its service offering to include expert testimony services in the court system to help defend business and property owners in eminent domain, or similar business litigation matters. Since merging Integrity Valuations, Mr. Rodriguez has led over 500 business appraisal and valuation projects.

Mr. Rodriguez's most recent accolades include becoming one of The Veld Group's most successful business brokers, where he has been responsible for over 100 business sale transactions to date. Mr. Rodriguez's attributes his highly successful career to his extensive experience, professional approach, and diligent work ethic. Mr. Rodriguez spends his leisure time pursuing his hobbies and passions, which include international travel, golf, running and boxing. Robert also volunteers with a local organization that tutors elementary students in math and science. Robert Rodriguez is fluent in Spanish, and likely closes more California business sale transactions in Spanish than any other broker.