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when selling your business

When selling your business, one of the earliest (and most important) decisions is how the transaction will be legally structured. Different legal structures affect you and your business in different ways. Below, we share the three most common legal structures and the factors that drive which structure may be best for you.

You'll notice that within each transaction structure there are many nuances and exceptions; this is why we always recommend engaging an experienced legal counsel and tax advisor to advise you on how each structure may affect you. Ideally, your legal counsel will be involved at the Letter of Intent (LOI) stage to help negotiate specific legal structure terms into the LOI. This will help you avoid complications, delays, or re-negotiations later in the transaction.

ASSET SALE

An asset sale is when the buyer purchases the assets of your business directly from your company. The buyer also typically agrees to assume certain liabilities of your company (though this is not required); usually these are related to the assets purchased, such as accounts payable or contractual obligations. A buyer typically agrees to purchase all or substantially all of the assets of your business (but it is possible for a buyer to purchase a more limited set of assets).

A buyer will typically form a new operating entity (but may use an existing operating entity) in order to purchase the assets (and assume liabilities); this new operating entity will now be "the company". You as the seller will maintain ownership of the legacy business entity (most sellers dissolve the legacy entity after a sale).

EXAMPLE ASSETS

- Equipment
- Inventory
- Customer lists
- Intellectual property
- Real estate
- Permits and Licenses
- Contract rights
- Accounts receivable

EQUITY SALE

A stock sale (in the case of corporations) or membership interest sale (for LLCs) is when the buyer purchases the ownership of the legal entity of your business. From a legal perspective, nothing about your company changes except for the owner.

MERGER

In a merger, two legal entities (your company and the buyer's entity) combine into one legal entity, with the surviving entity succeeding to all of the assets and liabilities of both entities. A merger can take different forms (e.g., direct, indirect, forward, reverse, triangular), but the most common form is when your company combines with a subsidiary entity of the buyer and your company survives as new subsidiary entity of the buyer (this is called a reverse triangular merger).

TAX RATES & PURCHASE PRICE ALLOCATION

The purchase price in an equity sale structure is generally taxed at the capital gains rate and does not require a purchase price allocation.

For asset sales and certain mergers, the purchase price must be allocated across each class of assets in your business. The purchase price allocation schedule – how much of the purchase price is assigned to each asset class – is a negotiated document and affects the taxes you will pay on the purchase price since different asset classes are taxed at different tax rates.

Example: Depreciated Assets

For example, for depreciated assets, if the amount allocated to a fixed asset exceeds your tax cost basis (which could be $0 if the fixed asset is fully depreciated), the difference could be taxed at a special tax rate called the depreciation recapture rate.

Example: Goodwill & Intangibles

After a fair market value has been assigned to all individual assets, typically the remainder of the purchase price will be allocated to "goodwill" and "intangibles." These asset classes are taxed at the capital gains rate, which is generally lower than the ordinary income rate. For businesses where the majority of the purchase price is allocated to goodwill and intangibles, the tax treatment more closely resembles an equity sale structure.

YOUR COMPANY'S **TAX STRUCTURE**

How your company is legally structured and taxed plays a large role in determining your preferred transaction structure. There are many nuances to tax treatment and laws, which can vary from state to state. We recommend you always consult your tax advisor and legal counsel to understand how possible deal structures may impact your taxes.

As an example, if your company is taxed as a "C corporation," an asset sale may trigger a "double taxation" of the purchase price, as the C corporation pays taxes on the gains from the asset sale, and then the distribution of proceeds to owners of the C corporation is taxed as income to those owners.

As another example, a buyer of an "S corporation" in an equity sale structure will often seek to make a special "Section 338(h)(10) election" under federal tax laws so that the equity sale is treated as an asset sale for tax purposes. This can create a win-win solution when most of the purchase price is allocated to goodwill or intangibles, as in these cases the seller's tax treatment closely resembles an equity sale (making the tax treatment a neutral point), while the buyer and go-forward business benefit from a "stepped-up" basis in the S corporation's assets (allowing for larger depreciation and amortization tax deductions).

TRANSFERS, CONSENTS, & RISK ALLOCATION

For **asset sales**, everything under the legacy business entity must be transferred to the new operating entity, including regulatory permits, licenses, and contracts (such as leases, customer or supplier contracts, and employee contracts). For most contracts, the counterparties must consent in writing to "assign" the contracts to the new entity. Regulatory permits and licenses also generally require the approval of the applicable regulator.

For **equity sales and most mergers**, while most contracts won't require consent to transfer, some contracts may have a provision requiring consent to a "change of control" (usually triggered when selling 25 - 50% or more of the company's stock or membership interest). Most regulatory permits and licenses will still require approval of the applicable regulator in an equity sale or merger structure.

If your company has multiple owners or investors, your governing documents may require consent of a majority or all such owners or investors regardless of the transaction structure. Without such a requirement, most states' laws require at least majority approval for an asset sale or merger, and an equity sale generally requires consent of every owner.

Nearly all buyers require that the seller remain liable for anything prior to the transaction, which is automatically the case in an asset sale. In an equity sale or merger, buyers will require the seller to contractually indemnify the buyer for pre-transaction matters (so that the result is largely the same as an asset sale).

Founded in 2004 and headquartered in Scottsdale, Arizona, Montage Partners is a people-first private equity firm dedicated to helping established businesses reach transformative growth. Montage Partners is actively seeking new investments in companies in the U.S. with EBITDA between $1.5 million and $7 million.
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