

# BUYING OR SELLING A CORPORATE BUSINESS: STOCK OR ASSETS

ZOLMAN CAVITCH\*

DAVID L. HOEHNEN\*\*

*The authors discuss the tax and nontax factors which should be considered in determining whether a taxable sale of a corporate business should be effected as a stock or as an asset sale.*

Probably the single most challenging area of business law practice is the purchase or sale of a corporate business. Here, perhaps more than in any other area, the lawyer's knowledge of diverse legal rules, his expertise in drafting, and the soundness of his business judgment, are at their greatest premium.

This article will explore only a *part* of this subject; namely, the more important factors which should be considered in determining whether a taxable sale of a corporate business should be effected as a stock sale or as an asset sale. That is, should the individual shareholders merely sell their stock, or should they cause the corporation to sell its assets, with perhaps a liquidation of the selling corporation following the sale?

The present discussion is limited to an inquiry of *taxable type* transactions. Thus this article does not include those methods of buying and selling a corporate business that qualify as tax-free organizations for income tax purposes.<sup>1</sup> By excluding the tax-free reorganization, however, we are still left with the great bulk of purchase and sale transactions. This is true because in order to effect a tax-free reorganization, the sellers ordinarily must receive exclusively stock of a purchasing corporation, a type of transaction which is usually feasible

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\* Mr. Cavitch (A.B., J.D., University of Michigan) is a partner in the law firm of Grossman, Familo, Cavitch, Kempf & Durkin, in Cleveland, Ohio, and a member of The Cleveland and The Ohio State Bar Associations and the Corporation Law Committee of The Ohio State Bar Association.

\*\* Mr. Hoehnen (A.B., Purdue University; J.D., Washington University) is an associate in the law firm of Grossman, Familo, Cavitch, Kempf & Durkin, in Cleveland, Ohio, and a member of The Cleveland Bar Association.

<sup>1</sup> Excluded are sales of assets or of stock solely for the voting stock of a corporate purchaser (Int. Rev. Code of 1954, § 368(a)(1)(B), (C)), and statutory mergers or consolidations (Int. Rev. Code of 1954, § 368(a)(1)(A)). Included are all such sales for cash or the purchaser's promise to pay cash in the future, irrespective of whether the purchaser is a corporation, an individual, a partnership, or a trust. For a discussion of tax-free reorganizations, see Cavitch, "Reorganization Techniques in Corporate Planning," 19 Bus. Law. 429 (1964).

only where the purchaser is a large, publicly-held corporation. Although lawyers are sometimes faced with this situation, the great majority of purchase and sale transactions involve the payment of cash, payable either in one lump sum or in installments over a period of years. Specifically this discussion will be an exploration of those factors which may be pertinent in choosing between a purchase and sale of stock for cash, on the one hand, and a purchase and sale of assets for cash, on the other hand.

## I. NONTAX FACTORS: THE DIFFERING CONSEQUENCES OF THE ASSET SALE AND THE STOCK SALE

### A. *Unknown or Undisclosed Liabilities of Seller*

One of the more important nontax factors is the degree of risk to the purchaser with respect to unknown or undisclosed liabilities of the corporation which is to be sold. In a stock sale, the purchaser bears the initial risk in this respect. Clearly, the stock to be purchased is worth an amount equal to the corporation's assets, including such intangible assets as good will, if any, less the amount of its debts. But at any given moment it is usually impossible to assert with certainty that a corporation has precisely so many dollars of debt. The corporation may, for example, have breached a product warranty on account of a sale already made, but no demand has yet been made by the aggrieved party. Similarly, tort liabilities not completely covered by insurance may yet be asserted which relate back to a time prior to the stock sale. Perhaps even more likely, the corporation may later be proven liable for an income tax deficiency which relates to the period prior to the date of sale. In these situations, and others, the later discovery of these obligations not taken into account in negotiating the purchase price, will mean that the purchaser has overpaid for his stock.

In most stock sales, this risk of overpayment can be minimized, perhaps eliminated, if the selling shareholders give full personal warranties that the only debts and liabilities of the corporation which relate to the period prior to the sale are those which are set forth on the relevant balance sheet. Sometimes such warranties can be made even more effective if a part of the purchase price is held in escrow for a few years. But the initial risk is on the purchasers, and adequate protection against this risk is sometimes a difficult part of the negotiating process.

By contrast, in an asset deal the contract will stipulate that the selling corporation will pay all of its own debts, or it will set forth the

specific debts which the purchaser is assuming or taking subject to.<sup>2</sup> In the usual asset deal, there is therefore little danger that the purchaser will be burdened with debts of which it was not aware at the time of the purchase.<sup>3</sup>

### B. *Risk of Personal Liability for Corporation's Debts*

A second nontax factor is closely related to the first, where our concern was that the purchaser in a stock sale might pay an excessive price for the stock. In a stock sale, however, the purchaser does not expose himself to personal liability for any of the debts of the purchased corporation; ordinarily, his maximum risk is the price he pays for the stock.<sup>4</sup> In an asset sale, on the other hand, the purchaser will be personally liable for those debts which it expressly assumed. More frightening is the possibility under certain circumstances that the purchaser might be personally liable for debts of the seller which the parties agreed in their contract would be paid by the seller. Thus, if the Ohio Bulk Sales Act<sup>5</sup> is violated, the purchaser may be liable for debts which it did not bargain for. Or, if the asset sale is held to be a fraud on the seller's creditors, those creditors may be able to impose a liability on the purchaser.

In this latter connection, it should be noted that several cases have held that one type of fraud on the seller's creditors is committed where the purchaser pays the purchase price directly to the shareholders of the selling corporation.<sup>6</sup> By circumventing the corporation, the purchaser may enable the seller to defeat its creditors, and the result may be an unexpected liability on the purchaser for the seller's debts. Thus in an asset sale the purchaser should ordinarily insist on paying the purchase price only to the selling corporation.

### C. *Dangling Minority*

A third factor, and one which poses no risk to the purchaser in an asset sale, is the possible problem of a dangling minority of shareholders refusing to sell in a stock sale, with the result that the purchaser

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<sup>2</sup> Where the purchaser is taking over a part or all of the seller's *known* obligations, the purchase price will be adjusted accordingly.

<sup>3</sup> *But see* subdivision I. B. *infra* for situations in which the purchaser might be personally liable for the seller's debts, whether known or unknown at the time of the sale.

<sup>4</sup> If the purchased corporation is subsequently liquidated, however, the purchaser (*i.e.*, the shareholder) will take over the corporation's assets subject to all the corporation's debts.

<sup>5</sup> Ohio Rev. Code Ann. §§ 1306.01-.09 (Page 1962).

<sup>6</sup> *E.g.*, *Shepard v. Commissioner*, 101 F.2d 595 (7th Cir.), *cert. denied*, 307 U.S. 639 (1939).

may end up with control of the purchased corporation but with one or more minority stockholders still in the picture. Since most purchasers, whether corporate or noncorporate, are reluctant to risk the possible interference from an outstanding minority stock interest,<sup>7</sup> the purchaser may insist upon an asset deal in those situations where it is not likely that all the stockholders of the corporation to be acquired will sell their shares.

#### D. *Stockholders' Approval and Appraisal Rights*

Another nontax factor is the possible problem of obtaining shareholder authorization for a selling corporation to sell in an asset deal. In an asset deal, formal approval must be obtained by the selling corporation from its shareholders, usually by a vote of two-thirds of the outstanding voting shares.<sup>8</sup> Even if the requisite approval is obtained, a nonassenting shareholder can nevertheless invoke the appraisal and buy-out remedy provided by the Ohio statutes.<sup>9</sup> The risk that the selling corporation might have to buy out for cash at a judicially appraised fair value as many as one-third or more of its stockholders can, in some situations, be a substantial hurdle to an asset deal.

In a stock deal, formal approval by the selling shareholders is not necessary. Those shareholders who wish to sell simply do so; they do not act through their corporation. By the same token, those stockholders who do not wish to sell are not thereby given a right to be bought out by the corporation, unless restrictions in the articles of incorporation, the code of regulations, or a private contract, have been violated in this respect.<sup>10</sup>

#### E. *Mechanical Ease*

A fifth factor is the mechanical ease of effecting the different transactions. Both the stock sale and the asset sale may take many

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<sup>7</sup> The possibility of minority stockholder interference is perhaps most serious in connection with a proposed liquidation or merger of the purchased corporation. In such event, the minority may be able to insist on receiving a pro rata share of each asset distributed in the liquidation or merger. *See, e.g., In re San Joaquin Light & Power Corp.*, 52 Cal. App. 2d 814, 127 P.2d 29 (1942).

<sup>8</sup> Ohio Rev. Code Ann. § 1701.76 (Page 1964). The articles of incorporation may provide that the two-thirds stockholders' approval be increased, or be decreased to not less than a bare majority. Ohio Rev. Code Ann. § 1701.52 (Page 1964).

<sup>9</sup> Ohio Rev. Code Ann. §§ 1701.76(C), 1701.85 (Page 1964).

<sup>10</sup> If the purchaser is a corporation, it may ordinarily effect either an asset deal or a stock deal simply by act of its directors. One notable exception is where the purchaser must amend its articles; for example, an amendment to broaden its purpose clause or authorize a larger issue of stock.

hours of negotiating, research, and thought to adequately handle the tax consequences and to draft the purchase and sale agreement. But once the deal is arranged, the closing of a stock sale is relatively simple if the purchased corporation has only a few selling shareholders. The shareholders endorse their stock certificates, deliver them to the purchaser, and the purchaser pays his cash or the first installment thereof. By contrast, the closing of an asset sale can be extremely burdensome, especially if there are many parcels of real estate to convey, items of chattel property to assign, or creditors of the selling corporation which must be notified to comply with the Bulk Sales Act.<sup>11</sup> The point is that from the standpoint of the lawyer's time and the risk of his committing errors, the asset sale is usually more burdensome than the stock sale.

## II. TAX FACTORS: THE DIFFERING CONSEQUENCES OF THE ASSET SALE AND THE STOCK SALE

Very generally, if there were no such thing as income tax consequences, the seller would usually prefer a stock sale, while the purchaser would usually prefer an asset sale. One or more income tax factors, however, will usually affect, and often control, the choice of method by which a corporate business is sold. The important tax factors which must always be considered are discussed in the following subdivisions. The first three factors pertain to tax consequences to the seller and will be of no concern to the purchaser, except, of course, that awareness of the tax problems to the other party is an important attribute of effective negotiating. The next two factors are pertinent to the purchaser and will be of no direct consequence to the seller. The last factor is pertinent to both.

### A. *Avoiding Double Tax to the Seller*

It will ordinarily be essential to the seller that only one taxable event occur. In a stock sale, this important objective is usually attained with certainty and with no complex analysis. The only sale or exchange which does in fact occur is the transaction whereby the individual shareholders sell their stock. That stock is a capital asset, and if it has been held by the selling shareholder for more than six months, the

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<sup>11</sup> Consider the following documents and transactions which might be involved in an asset deal in addition to the purchase and sale agreement: deeds for real estate; transfer documents for chattels; assignments of motor vehicles; amendment of qualified pension or profit sharing plan reflecting new employer; assignments of patents and trademarks; resetting of, or consent to, franchise agreements and licenses; transfer of experience rating with Ohio Bureau of Unemployment Compensation and Ohio Industrial Commission; and liquidation and dissolution of selling corporation.

gain he realizes, if any, will ordinarily be taxed as long-term capital gain. Save only for the situation where there may be a risk that his corporation is collapsible,<sup>12</sup> a single tax, at favorable capital gain tax rates, is assured.

In an asset sale, there is a risk that two taxable events may be imposed upon the selling group. For here the corporation will be selling assets, and if that sale is at a gain the basic rule is that the corporation will be taxed on that gain. Furthermore, the corporation has, by assumption, sold its working assets; it no longer has a business to conduct, and the normal desires of the shareholders will be to distribute the assets to themselves in a corporate liquidation. But the liquidation of a corporation is ordinarily a taxable event to the shareholders, the persons who receive the liquidating distributions. Usually, both the gain to the corporation and to the shareholders will be long-term capital gain, but the *double* capital gain tax will be unnecessarily expensive in most cases. Fortunately, in almost all cases one of two alternatives will be available to avoid one of the taxable events.

### 1. Complying with Section 337

One way of avoiding the double tax, and usually the more desirable, is to make certain that the sale of assets and liquidation of the selling corporation meet the qualifications of section 337 of the Internal Revenue Code. If those requirements are met, then most, perhaps all, of the gain realized by the corporation will be exempt from tax.<sup>13</sup> The general rule of section 337 is quite simple. Namely, both the sale and the distributions in complete liquidation of the corporation must take place within the twelve month period beginning with the adoption by the selling corporation of a plan of complete liquidation.<sup>14</sup> In the overwhelming majority of cases where a closely-held corporation proposes to sell all or substantially all of its assets, it is an easy matter to comply with this timing requirement. The only real need is to be sufficiently aware of it.

Even where this all-important timing requirement is clearly met, certain transactions may nevertheless be subject to corporate tax, or at least the Internal Revenue Service may contend that the corporate tax is payable. First, sales of inventory at a profit, even though

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<sup>12</sup> If the corporation is collapsible, gain may be taxed as ordinary income. Int. Rev. Code of 1954, § 341. For elaboration, see subdivision II. C. *infra*.

<sup>13</sup> By the same token, the corporation will not be able to deduct any loss. Hence, if assets will be sold at a loss, it may be important *not* to qualify under section 337.

<sup>14</sup> Int. Rev. Code of 1954, § 337(a); Treas. Reg. § 1.337-2(b) (1955); Rev. Rul. 65-235, 1965-2 Cum. Bull. 88.

made during the critical twelve month period, will be taxable to the corporation as will the sale of any installment obligations received on account of sales of inventory.<sup>15</sup> There is, however, a favorable and important exception to this unfavorable rule. If all the inventory attributable to a particular trade or business of the corporation is sold to one person in one transaction, then even the sale of inventory or installment obligations received on the inventory sale will be tax free.<sup>16</sup> In brief, the sale of inventory must be a bulk sale in the strictest sense of the term in order to come within the favor of section 337. Furthermore, the Service takes the position that sales of assets which were deducted as expense items when purchased by the selling corporation, are not within the favor of section 337.<sup>17</sup> The Service is probably wrong in this contention, but that may be small comfort to the client who has to contest a deficiency determination.

With respect to an asset sale that qualifies under section 337, the relatively new depreciation recapture rules<sup>18</sup> are fully applicable. That is, a part or all of the gain attributable to the sale of depreciable assets may be taxed to the selling corporation as ordinary income, notwithstanding the applicability of section 337.

A further possible tax consequence to the selling corporation will be relevant to a selling corporation which has maintained a reserve for bad debts. Such a reserve will probably have to be added back to income because of the liquidation of the corporation.<sup>19</sup>

Thus, although qualifying the sale and liquidation under section 337 can in many cases eliminate the double tax otherwise associated with an asset sale, it is not always completely effective. In a stock sale, by contrast, none of these exceptions written into section 337 applies. There is a single tax to the sellers, with no qualifications.

## 2. Maintaining Selling Corporation as Personal Investment Company

It will be observed that where the corporate tax is avoided pursuant to the statutory relief measure of section 337, the tax consequence to the shareholders of the selling corporation is ordinarily essentially

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<sup>15</sup> Int. Rev. Code of 1954, § 337(b)(1).

<sup>16</sup> Int. Rev. Code of 1954, § 337(b)(2).

<sup>17</sup> Rev. Rul. 61-214, 1961-2 Cum. Bull. 60.

<sup>18</sup> Int. Rev. Code of 1954, §§ 1245, 1250. See subdivision II. F. *infra*.

<sup>19</sup> *Arcadia Sav. & Loan Ass'n v. Commissioner*, 300 F.2d 247 (9th Cir. 1962); *Citizens Federal Sav. & Loan Ass'n v. United States*, 290 F.2d 932 (Ct. Cl. 1961); *Ira Handelman*, 36 T.C. 560 (1961); *C. Standlee Martin, Inc. v. Riddell*, 51 Am. Fed. Tax R. 1376 (S.D. Cal. 1956). Of course, the corporation must be liquidated or section 337 cannot possibly apply.

the same as it would be if they had sold their stock.<sup>20</sup> A tax will be paid at the shareholder level, usually at long-term capital gain rates, on the difference between the shareholders' basis for their stock and the amount received on the sale of the stock or the assets, as the case may be.

Sometimes, however, there is an alternative way of avoiding the double tax on an asset sale. In those situations where this alternative is advisable, the tax consequences may be far better than if a stock sale had been effected. That is, in some situations it will be advisable to refrain from liquidating the selling corporation. If the selling corporation is not liquidated, then, of course, section 337 will not be applicable and the gain, if any, to the corporation will be taxed. By not liquidating, however, the taxable gain at the shareholder level will be avoided. In some cases, avoiding taxable gain to the shareholders will be far more important than avoiding tax to the corporation.

Take, for example, this very simple illustration. A corporation has a single shareholder. His cost basis for his stock is only 100 dollars. The corporation's assets, minus its debts, have a fair value, however, of 1,000 dollars and those net assets have a cost basis to the corporation also of 1,000 dollars. A purchaser is willing to buy the assets subject to the debts for 1,000 dollars, or the stock for 1,000 dollars. Under these facts, note the following tax consequences. If the shareholder sells his stock for 1,000 dollars, he will have a 900 dollar capital gain, and he will pay a tax accordingly. Similarly, if the corporation sells its assets and liquidates under section 337, the corporation will have no tax, but the shareholder will receive the 1,000 dollar purchase price on liquidation of the corporation and he will have the same 900 dollar capital gain that he would have had if he had sold his stock. But suppose the corporation sells its assets and does not liquidate. The corporation will still have no tax, *because it has no gain*. The cost basis for its assets and the sale price are identical, so there is no need to obtain the favor of section 337. Furthermore, by not liquidating, the 900 dollar capital gain to the shareholder is avoided.<sup>21</sup> In addition, upon the shareholder's subsequent death, his estate or his heirs can

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<sup>20</sup> But see subdivision II. C. *infra* for a significant difference to the selling group if the corporation is collapsible.

<sup>21</sup> Presumably, the selling corporation will now be a private investment company. As such, extreme care must be taken to avoid the drastic personal holding company penalty tax imposed by section 541 of the Int. Rev. Code. This penalty tax can be avoided if the corporation either distributes as a dividend all of its after-tax income or, generally speaking, invests substantially in real estate. See Z. Cavitch, Ohio Corporation Law with Federal Tax Analysis §§ 1.13[5], 14.41[2][c] (1961) for a more detailed discussion of the intricate rules pertinent to this penalty tax.

liquidate the corporation without personal tax liability. This will generally be true because upon his death the shares will take a new basis equal to their then fair market value<sup>22</sup> and that, presumably, is the value of the assets which will be distributed on liquidation.

This alternative method of avoiding the double tax of an asset sale is not always available or desirable. Generally speaking, however, where the selling corporation has a relatively high basis for its assets, so that there will be little or no gain realized by the corporation on account of the asset sale, and where the shareholders have a relatively low basis for their stock, so that there will be a substantial gain realized by them on liquidation (or on a sale of their stock), the possible desirability of utilizing an asset sale and refraining from liquidating the selling corporation should be thoroughly explored.

### B. *Availability of Installment Reporting of Gain*

The second tax factor which may be important to the seller will be pertinent only where the purchase price will be paid over a period which includes two or more taxable years of the seller. Where the price will be paid in such installments, it may be important to the seller to be able to spread his income tax liability on account of that sale over the period during which the payments will be made. In short, it may be important to be able to elect the installment method of reporting taxable gain which is provided under section 453 of the Internal Revenue Code.

The shareholder who sells his stock, and the corporation which sells its assets, will be able to elect this installment reporting, provided that the cash received in the year of sale is not more than thirty percent of the total selling price.<sup>23</sup> But in an asset sale, as indicated above, the selling corporation will usually be liquidated. If so, the gain realized by the shareholders will not be attributable to the asset sale as such, but rather to the receipt of liquidating distributions; thus the installment method of reporting gain will not be available to the shareholders.<sup>24</sup>

In proper circumstances, the availability of installment reporting can be all-important to the seller. Suppose that S Corporation has assets, including good will, worth 100,000 dollars. S's cost basis of its assets is 40,000 dollars. Its sole shareholder, A, has a cost basis of 10,000 dollars for his stock. A purchaser is willing to buy either the assets or the stock for 100,000 dollars payable 10,000 dollars in the year of sale, and 10,000 dollars each year thereafter for nine years.

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<sup>22</sup> Int. Rev. Code of 1954, § 1014(a).

<sup>23</sup> Int. Rev. Code of 1954, § 453(b)(2).

<sup>24</sup> L. S. Krause, 26 CCH Tax Ct. Mem. 358 (1967).

Assume further that if the transaction is effected as an asset sale, the corporation will be liquidated within the time period prescribed by section 337.

If the transaction is effected as an asset sale, there will be no tax to the corporation, but *A* will have a 90,000 dollar capital gain. If the maximum tax of 22,500 dollars (twenty-five per cent of 90,000 dollars) is incurred, it will be payable all in the first year, while only 10,000 dollars cash will be realized on the sale.

If the transaction is effected as a stock sale, a 90,000 dollar gain will be realized by *A*, but the installment election can enable *A* to pay a maximum tax each year of 2,250 dollars (twenty-five per cent of the 9,000 dollar annual gain).

### C. Differing Consequence of Collapsible Corporation Status

The third tax factor—the differing consequence of collapsible corporation status—is the last of the tax factors pertinent exclusively to the seller. Some corporations are, or may be, collapsible as defined in section 341(b) of the Internal Revenue Code. Subject to certain qualifications, if a corporation has one, or relatively few, large assets—for example, an office building, or a shopping center—which are worth substantially more than they cost the corporation, and if those assets have been owned by the corporation for less than three years, there is likely to be a danger that the corporation is collapsible.<sup>25</sup> If so, a stock sale may result in the entire gain being taxed to the selling shareholders as ordinary income, rather than capital gain, with a maximum tax of seventy percent rather than twenty-five percent.<sup>26</sup> Where the taxable gain is large, that difference can be prohibitive.

In an asset sale, however, the consequence of the corporation being collapsible is quite different. In that event, nothing that would otherwise be capital gain is converted into ordinary income. In other words, in an asset sale, unlike in a stock sale, a status of collapsibility does not result in converting capital gain into ordinary income. Instead, the selling corporation becomes ineligible for the relief from taxation provided by section 337. An asset sale by a collapsible corporation followed by a liquidation will result in the double tax consequence discussed above,<sup>27</sup> a consequence which is bad enough but which is

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<sup>25</sup> For the complexity of defining a collapsible corporation, see Z. Cavitch, *Ohio Corporation Law with Federal Tax Analysis* § 14.41[2][c][ii] (1961).

<sup>26</sup> Even if the corporation is collapsible, however, the sale of stock will give rise to capital gain if one of the exceptions set forth in sections 341(d) or (e) of the Int. Rev. Code is met.

<sup>27</sup> See Int. Rev. Code of 1954, § 337(c)(1)(A); *Estate of Van Heusden v. Commis-*

usually far less burdensome than the treatment of a large gain as ordinary income. Stated differently, a double capital gain tax, onerous as it may be, is usually less expensive than a single ordinary income tax.<sup>28</sup>

#### D. *The Differing Basis Rules to the Purchaser*

The first of the two tax factors relevant exclusively to the purchaser is the differing basis rules resulting from the two types of transactions. In an asset purchase, the basis rule is simple: the purchaser, whether it be an individual, a group of individuals, or a corporation, obtains a basis for each asset equal to the purchase price of that asset.<sup>29</sup> Accordingly, to the extent depreciable property is purchased, the purchaser gets a new depreciation base equal to his cost. Similarly, if inventory is purchased, the purchaser will acquire a new basis equal to its cost.

In a stock purchase, the rule is precisely the same, but its effect is quite different. Thus the purchaser of the stock obtains a basis for the stock equal to the purchase price, but the purchase price does not affect the basis of the underlying assets owned by the purchased corporation. Depreciation deductions continue in the same amount as before, and its cost of goods sold is not affected. If the cost of the stock is greater than the book value of the corporation's assets, then even though that higher price is attributable to the fact that depreciable property is worth more than book value, or that inventory is worth more than book, the purchaser does not get the tax benefit of increased

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sioner, 369 F.2d 119 (5th Cir. 1966); Treas. Reg. § 1.337-1 (1955). Further explanation appears in subdivision II. A. *supra*.

<sup>28</sup> Suppose that Corporation S has net assets worth \$500,000, having a basis to the corporation of \$200,000. The sole shareholder, A, has a basis for his stock of only \$50,000. The purchaser will pay \$500,000 in cash either for the assets or the stock. Moreover, there is a significant danger that the corporation will be deemed collapsible.

If the transaction is effected as a stock sale, A's gain of \$450,000 may be taxed as ordinary income. Assuming a tax bracket of seventy per cent, a tax of \$315,000 will be incurred.

If the transaction is effected as an asset sale, the corporation's collapsibility may result in the corporation's gain being taxed to it. Assuming that all of the corporate gain of \$300,000 is attributable to capital assets, or noninventory assets used in the business, the gain will be taxed at twenty-five per cent, resulting in a tax of \$75,000. If the corporation is liquidated, \$425,000 (the \$500,000 selling price less the \$75,000 corporate tax) will be distributed to A, resulting in a *capital gain* to him of \$375,000, and a maximum tax of \$94,000 (twenty-five per cent of \$375,000). The aggregate double capital gain tax will be \$169,000, as compared with the single ordinary income tax of \$315,000. Both are bad, but one is worse.

<sup>29</sup> Int. Rev. Code of 1954, § 1012.

tax deductions. This difference between an asset purchase and a stock purchase can be extremely meaningful to a purchaser.

Fortunately, there is a solution even where the transaction is cast as a stock purchase. If the purchaser forthwith liquidates the corporation which he has just purchased, the purchaser will obtain a new basis for the underlying assets transferred to him on the liquidation. That new basis will generally be equal to the cost of the recently purchased stock. This will be true whether the purchaser is an individual<sup>30</sup> or a corporation.<sup>31</sup>

One significant caveat should be mentioned. If the purchaser is not a corporation, he can operate that business as a proprietorship or as a partnership, as the case may be, and there will be no problem from this standpoint. The chances are, however, that the business can be operated better as a corporation; presumably, there were valid reasons for it having been in corporate form when the stock was purchased. If the purchaser, having liquidated the corporation, subsequently reincorporates the business assets, the Internal Revenue Service will surely contend that the liquidation should be ignored, and the Service will probably succeed. The tax consequences will be that the new corporation will *not* obtain the new basis which was sought and, perhaps far worse, any assets which are not reincorporated by the individual purchasers—for example, cash—will be treated as a dividend distribution from a continuing corporation.<sup>32</sup> A far better solution, one which is free of this liquidation-reincorporation tax pitfall, is for the individuals who propose to purchase stock to *first* form their own corporation. The new corporation should then purchase the stock of the old corporation. The parent corporation may then cause the purchased corporation to be liquidated and its assets transferred to the parent. The basis adjustment will be effected without any other tax consequences, provided that the liquidation occurs no later than two years after the date of the stock purchase.<sup>33</sup>

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<sup>30</sup> Int. Rev. Code of 1954, § 334(a).

<sup>31</sup> Int. Rev. Code of 1954, § 334(b)(2). This generally favorable rule will be applicable even though the purchasing corporation is newly formed for the purpose of purchasing the stock. See *Cromwell Corp.*, 43 T.C. 313 (1964), *acquiesced in*, 1965-2 Cum. Bull. 4.

<sup>32</sup> This is precisely the liquidation and reincorporation tax pitfall which has been the subject of several recent cases. *Davant v. Commissioner*, 366 F.2d 874 (5th Cir. 1966), *cert. denied*, 386 U.S. 1022 (1967); *Moffatt v. Commissioner*, 363 F.2d 262 (9th Cir. 1966), *cert. denied*, 386 U.S. 1016 (1967), *noted in*, 28 Ohio St. L.J. 325 (1967); *Bard-Parker Co. v. Commissioner*, 218 F.2d 52 (2d Cir. 1954), *cert. denied*, 349 U.S. 906 (1955); *E. T. Griswold*, 45 T.C. 463 (1966).

<sup>33</sup> Int. Rev. Code of 1954, § 334(b)(2).

### E. *Availability of Net Operating Loss Carry-Over after the Sale*

The second tax factor relevant to the purchaser will be pertinent if the corporation to be purchased has an operating loss carry-over. In such event the purchaser will want, if at all possible, to obtain the tax benefit of that loss carry-over. If the purchaser purchases assets, there is no possible way for it to acquire that tax benefit.<sup>34</sup> If, on the other hand, the stock is purchased, and the following conditions are met, the loss carry-over will still be available to the purchased corporation notwithstanding the complete change in its ownership. First, the purchased corporation must not be liquidated within two years; such a liquidation, although it affects the basis adjustment discussed above,<sup>35</sup> would clearly terminate the continuing availability of a loss carry-over.<sup>36</sup> Second, the purchased corporation must continue to carry on the same business that it operated before the stock purchase.<sup>37</sup> Third, the availability of the loss carry-over must not have been the principal purpose motivating the purchaser to buy the stock.<sup>38</sup>

### F. *Differing Impact of Depreciation Recapture Rules*

The last of the pertinent tax factors is the differing impact of the relatively new depreciation recapture rules.<sup>39</sup> This is a factor of which *both* the purchaser and the seller must be aware, because the party who is not alerted to it will likely pay a high price for his ignorance. In order to appreciate this varying impact, a brief condensation of those rules must be set forth.

Generally speaking, if depreciable personal property is sold at a gain,<sup>40</sup> that gain will be taxed as ordinary income rather than the usual capital gain, to the extent of the depreciation deductions allowed with respect to such property since the beginning of 1963.<sup>41</sup>

A somewhat similar rule applies to the sale of depreciable real property, but the rule is more complex and substantially less strict. Here, similar to the rule respecting personal property, any gain recog-

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<sup>34</sup> Section 381(a) of the Int. Rev. Code, which enables the acquiring corporation in an asset deal to succeed to the loss carry-over of the purchased corporation, is applicable only to a *tax-free* asset transaction.

<sup>35</sup> See subdivision II. D. *supra*.

<sup>36</sup> Int. Rev. Code of 1954, § 382(a).

<sup>37</sup> *Id.* A new business may, however, be added provided that the old business is not discontinued. *Commissioner v. Goodwyn Crockery Co.*, 315 F.2d 110 (6th Cir. 1963).

<sup>38</sup> Int. Rev. Code of 1954, § 269.

<sup>39</sup> Int. Rev. Code of 1954, §§ 1245, 1250.

<sup>40</sup> Gain on the sale of depreciable personal property may be defined as the amount in excess of depreciated cost. Int. Rev. Code of 1954, § 1001.

<sup>41</sup> Int. Rev. Code of 1954, § 1245.

nized on the sale of depreciable real property will be taxed to the seller as ordinary income, not capital gain, to the extent of the depreciation deductions allowed with respect to such property since the beginning of 1964.<sup>42</sup> But this general rule is diluted by the following limitations:

(1) If the real property has been held for one year or less, the amount added to income will equal the depreciation actually allowed as a tax deduction.

(2) If the real property has been held for more than one year, the amount added to income is only the amount of depreciation actually allowed as a tax deduction since the beginning of 1964 which is in excess of straight-line depreciation.

(3) The amount otherwise added to income is reduced by one percentage point for each month that the real property was held in excess of twenty months; thus, after ten years (120 months) there can be no depreciation recapture with respect to real estate.<sup>43</sup>

If the transaction is an asset sale, then obviously the selling corporation is burdened with these rules. This means that the selling corporation and, in effect, its shareholders pay the tax cost. By contrast, if the transaction is a stock sale, the selling shareholders are not burdened at all, inasmuch as they do not sell or transfer depreciable assets of any kind. However, if the purchaser of the stock decides to liquidate the purchased corporation, perhaps in order to obtain a basis adjustment, the depreciation recapture rules apply. It is important to bear in mind that in this type of liquidation, the transfer of depreciable assets in liquidation is treated for this purpose just as though those assets were being sold for cash in an amount equal to their then fair market value. Accordingly, the added tax cost of these recapture rules will in effect be borne by the purchaser.

As long as both the purchaser and the seller are aware of the differing impact of these rules, the negotiated purchase price will reflect the fact that one of the parties will be burdened with this extra cost. But where one of the parties negotiates without knowledge of the differing impact of these rules he will likely pay a high price for his ignorance.

### III. CONCLUSION

Fortunately for lawyers, there is no broad generalization which tells the seller or the purchaser that a particular factor should be all-important to him to the exclusion of others. Discretion and good judgment are still the essential ingredients in working in this difficult area. For example, if there is a significant difference in the relative desires

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<sup>42</sup> Int. Rev. Code of 1954, § 1250.

<sup>43</sup> *Id.*

of the parties to make the deal, the party who is less concerned will have a more effective voice than the anxious party in setting the form of the transaction. By way of further example, if the seller has no reputation for honesty and integrity, and the purchaser is skeptical of the seller's operations, the purchaser may be adamant about purchasing assets and picking and choosing specific liabilities. Or, if the purchase price must be paid in installments over a period of years, it may be overwhelmingly important for the seller to have available the installment reporting of his gain; in such event, the purchaser may have to accept a stock purchase. In short, as in so many of the decisions lawyers are called upon to make, the specific answer will depend upon the particular circumstances involved.