Mergers & Acquisitions Primer:

Capital Gains vs. Ordinary Income Tax

By Christine Malafi, Esq.

The most common forms of businesses include sole proprietorships, partnerships, C-corporations, and S-corporations. When a business entity is sold, there is a tax impact based on the capital gain and ordinary income realized from the sale. When a business owner sells their business, the capital gain is generally the difference between the adjusted basis and sale price, and the ratio of capital gain v. ordinary income tax depends on the type of business and assets being sold. Let's take a look at some considerations for different entity types – enough to make conversations with your (or your client's) accountant slightly less taxing.

Sole Proprietorships

In a sole proprietorship, a sale is treated as if each asset is sold separately. Most assets trigger capital gains taxes, but the sale of some assets, such as inventory and unrealized receivables, are taxed at ordinary income tax rates. It's important to check with a tax advisor regarding the types of assets that incur ordinary income tax compared to capital gains tax.

Partnerships

For a partnership, the sale of a partnership interest generally results in capital gain or loss treatment to the selling partner. However, any part of the gain or loss from unrealized receivables or inventory items is subject to ordinary income tax rates.

C-corporations

When selling a C-corporation, the choice between structuring the sale as a stock or asset sale impacts the taxes levied. Since C-corporations are not pass-through entities, the company pays taxes on its income, and all income for C-corporations is treated as ordinary income. This means that C-corporations are taxed at ordinary corporate income tax rates as compared to capital gains tax rates.

Stock sale proceeds are taxed at the capital gains rate (single taxation) while asset sale proceeds are taxed at ordinary corporate income rates and then again at the individual level upon distribution to the shareholders (double taxation).

Sellers should be aware that shareholders will be taxed at different rates depending upon the type of distributions that the shareholders receive. For instance, ordinary, non-qualified dividends mean ordinary income rates while qualified dividends that meet certain requirements could mean capital gains rate. This could also be taxed as a liquidating distribution which is taxed at capital gains rates (it may seem like the same thing as a qualified dividend, however if the individual has capital losses, they could be used to offset such gains).

S-corporations

When selling an S-corporation, both a stock and asset sale generally result in single taxation at the shareholder level. The U.S. Tax Code allows buyers and sellers of the stock of an S-corporation to make a section 338(h)(10) election so that a qualified stock purchase will be treated as an asset purchase for federal income tax purposes.

This election is made jointly by the target shareholders and the purchasing corporation and treats the transaction as if it were an asset sale rather than a stock sale. Although the shareholders sell stock to the buyer, they pay taxes as if they sold the company's assets.

Since the company itself does not pay taxes on the sale of its assets, the income from the sale of its assets passes through to the shareholders, who are responsible for paying taxes.

Asset sales are calculated individually for each asset. If the company that sells the assets is an S-corporation that was a C-corporation within the last five years, then the S-corporation's asset sale could trigger corporate-level taxes.

Goodwill

The goodwill of a business, the value of the reputation of the business, is taxed as capital gain income.

Non-Compete Agreements

Most of the time, the owner of a business being sold will agree not to compete with the business being sold for a period of time (and perhaps within a certain geographic area), and a value/portion of the purchase price will be allocated to this agreement, the value of which will be taxed as ordinary income.

When working with clients on tax issues stemming from the sale of their business, always work with a tax advisor to avoid IRS-related issues regarding capital gains vs. ordinary income taxes.

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Christine Malafi, Esq.
Senior Partner at Campolo, Middleton & McCormick, LLP
Christine Malafi is a Senior Partner at Campolo, Middleton & McCormick, LLP, recognized by Forbes as a Top Corporate Law Firm in America. She chairs the Corporate Department and you can reach her at cmalafi@cmmllp.com