Asset Versus Entity Sale?

Three Things To Consider

There are usually only two structures that the sale of a medical practice can take: selling some or all of the assets (an asset sale), or selling the actual corporate entity (Corp, LLC, LLP, etc.—an entity sale). If you are a sole proprietor, not incorporated, your only choice is to do an asset sale, as you have no corporate entity to sell. That said, a corporate entity such as an S-Corp or LLC can sell its assets and do an asset sale between it and an individual or another company.

If you're considering buying or selling a medical practice and want to know which type of sale is most appropriate for you, it's important that you (1) understand what assets are; (2) how liability pertains to each kind of sale.

Let's go a little deeper and compare these two types of sales…

Whether you are selling your company (an entity sale), or are a sole proprietor or company selling the assets of your company (an asset sale), the value of almost any medical practice boils down to its assets. Let's go into a bit more details about how assets are classified.

<u>Tangible Assets</u>

This is the "stuff" in the office. The furniture, fixtures, medical equipment. Even the decorations, books, chairs in the waiting room. Whatever objects and equipment the seller intends to let go as part of the sale of their medical practice. When it comes time to sell, a seller will quite literally need to go through the whole office(s) and itemize the estimated value of everything.

<u>Intangible Assets</u>

These are the highly valued parts of the business that are not so easily quantifiable but are quite important, such as any intellectual property associated with the business (copyrights, trademarks, websites, web domains, etc.), as well as the value of the business name, address and assignability of the lease, retained employees, contracts with insurance companies, and other goodwill. In fact, when you hear the term, "Goodwill," it is often just a simple word used to cover many of the intangible assets that lie outside of easily identified intellectual property. This is also part of what makes the practice continue to grow over time, it's reputation. (If this is still confusing, we'd be happy to explain it in more detail over the phone or through email.)

<u>Liability</u>

Asset Versus Entity Sale?
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Liability is loosely translated as any kind of legal claims or debts owed by the practice. The degree to which the buyer of a medical practice takes on the liabilities of a practice depends to a large extent upon what type of sale you are doing.

Liability in an Entity Sale
Because a corporate entity shields its owner(s) from personal liability, any liabilities are liabilities of the corporation itself, and thus usually transfer over to the new owner in the sale of a medical practice. In short, the company being bought will need to resolve its claims and debts regardless of who is behind the corporate veil (who owns it).

Because of this, a buyer who is interested in buying the corporate entity will want to know all liabilities ahead of time. Buyers may also ask that the sales contract include provisions that all known debts are paid down or paid off before closing. And because a company may later be sued for actions taken before the entity was sold to a new owner, many potential buyers of a practice will ask that the sales contract include a provision that the seller be responsible for any claims related to any undisclosed or unexpected liabilities that may show up after closing related to issues that started *before* closing. Wow, quite a sentence there.

If the buyer of a medical practice feels that the valuation (price) of the practice is too high relative to its liabilities, they may use the liabilities as a negotiating tool to lower the valuation of the practice and buy it for less.

Liability in an Asset Sale
In the vast majority of cases, liability does not follow an asset. For example, if you possess an asset like a couch in your waiting room, and you sell it, you would not normally be held liable for the injuries or issues created by the couch once it is owned by a new party. That said, part of any good sales contract will contain a provision that all assets are in good working order before the sale to the best of the seller's knowledge. As my wife (an attorney) is fond of saying, anything can be litigated. But, alas, this is considered quite rare.

Further, when a sole proprietor or company sells its assets (but not the actual company), the new owner is not held responsible for any existing debts or claims related to the practice, except as written into the sales contract.

Tax Consequences

Another major consideration when choosing how you will organize your sale is to know something about the tax consequences of each kind of sale.

Asset Versus Entity Sale?
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<u>Mandatory disclaimer</u>:
Before we go into the tax stuff here, I want to put out there that you should be consulting a CPA before you make a final decision on how you transfer the business. The advice we give is based on our knowledge and experience, but we're not CPAs, and we want you to know that.

Okay, let's keep it simple… Most of us know that ordinary income tax rates can vary and go north of 35% depending upon your individual tax situation. The long-term capital gains rate tends to hover around 15%.

Most of us of course would prefer to be taxed at as low a rate as possible, and most entity sales will be taxed at the long-term capital gains rate.

In contrast, in an asset sale, at least some of the assets will be taxed at ordinary income tax rates.

In the first example, an entity sale, the stock of the company is trading hands, and the gain is like a long-term stock gain for the sellers (long-term capital gains rate).

In an asset sale of a medical practice, let's say you, the seller, have made a list of all the furniture and fixtures that are part of the sale. You bought that couch in the waiting room for $1,000, depreciated it over the last five years on your tax returns, and then valued it at $200 on your list of assets when you sold the practice. The difference between the value of the fully depreciated asset ($0) and the sale price ($200) is taxable at ordinary income tax rates. Multiply that out over all your fixed assets, and you can see where this can lead.

It should be noted that goodwill and other intangibles such as intellectual property, may be taxed differently, in fact more favorably, for a buyer. For this reason, during negotiations, a seller will want to minimize the value of tangible assets and amplify the goodwill, while the buyer will seek to do the opposite.

Another consideration for C-Corp sellers: While above I wrote that one corporation can sell its assets to another, if the seller is organized as a C-corp, doing an asset sale exposes the shareholders to the specter of double-taxation. Whereas, if the entity is sold in its entirety, the sale of the stock of the corporation results in only one tax bill.

So Which Should I Do? Entity or Asset Sale?

The key difference is in how you frame it.

Asset Versus Entity Sale?
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Most savvy sellers organized as a corporate entity will want to sell the corporate entity. Even if the buyer is able to have some exceptions made in the sales contract to accepting certain liabilities, they are accepting all others.

In an asset sale, it's kinda the opposite: a buyer can pick and choose which assets they want and which they don't, likely cherry-picking the most valuable assets and leaving the others behind. They will probably have zero liabilities related to the assets they acquire, and will receive a more favorable tax treatment from an asset sale, getting write off big parts of the sale once it's over.

Given the points covered above, the bottom line is that a corporate entity with no liabilities will most likely want to sell the whole entity, while a buyer will get more favorable tax treatment and reduced liability if it's an asset sale. (And if the seller is a sole proprietor, there's no choice: it will be an asset sale.)

In Summary

<u>Asset Sale</u>

- Sell all assets of a medical practice
- Only choice for sole proprietors
- May be easier to deal with for smaller businesses tax-wise
- Can be done as an individual or as a corporate entity
- Liability for assets only
- Tangible assets individually taxed at ordinary income tax rates depending upon amount depreciated vs. sales price for seller (less advantageous for seller); goodwill, intangibles, and covenant not to compete can be separately valued and depreciated over time (more advantageous for seller).

<u>Entity Sale</u>

- Sale of entire corporate entity (S- or C-Corp, LLC, etc.)
- May be more advantageous for seller tax- and liability-wise.
- Can only be done entity-to-entity, no sole proprietors.
- Liabilities carry over to new owner unless exceptions are made
- Seller tends to be taxed at long-term corporate gains rates, which tend to be lower than ordinary income tax rates.

If you're wrestling with what kind of sale would be best for your individual situation, we'd be happy to discuss the pros and cons with you. Reach out to us now. The first call is free.