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Executive Advocate

Taking Advantage of a C Corporation

The Problem

Another broker in our firm had a successful HVAC company listed. Several buyers had made offers the seller accepted; however, the seller held the master license required by the state and although the seller would agree to keep a relationship with the buyer's company so that his license could be used until the buyer had their own, the SBA would not accept this for more than a year and the license required two years of experience.

Scope

My buyer was managing field crews in a different but similar business and was looking for his own opportunity. We realized his management expertise would be the logical next step to take an existing HVAC company to its next level of growth and began to target those. When we found this opportunity it seemed to be the perfect fit; however, my buyer didn't have a master's license and couldn't afford the business without being able to borrow.

The C Corporation Solution

Most small business owners avoid forming a C Corporation because of the "double taxation." First the government taxes the business on its tax return; and then it taxes the owner on his or her personal return. Small business owners prefer pass-thru tax entities that have no tax at the business level. These entities include sole proprietorships, partnerships, and S Corporations. Other types such as LLPs and LLCs can be taxed liked these, which is why they are so common.

However, your government really likes C Corporations and has provided incentives for people to form them. These are often "up front" tax incentives that can be used to make a deal happen that might not be otherwise possible. They allowed this deal to come together.

If a buyer cannot get funds from a lender based on the future cash flows of the business being purchased (like an SBA loan), he or she can either look to their personal assets they can collateralize, or to the seller's assets.

We started with our buyer's assets. He was first able to raise some money with the equity in his home using a second mortgage or HELOC (Home Equity Line of Credit). This may be the cheapest money available, especially if there is an existing mortgage. That mortgage company is already familiar with the collateral and often eager to lend more against it. Origination fees and interest rates are very favorable.

We next found considerable savings in his 401(k) retirement plan. These are often overlooked because there is a penalty for withdrawing them before age 59 1/2. What we were able to do is have the buyer form a C Corporation and then as a benefit to its employees (him), offer them a 401(k). The buyer could then roll-over his former 401(k) into the one offered by his own company. That 401(k) can then invest a new business purchase. This also works with IRAs, SEPs, SIMPLE plans, etc.

The IRS looks hard at these arrangements and will worry that it represents self-dealing. The government allows a tax benefit for retirement contributions only when the money goes to an account where the owner can't use them for personal benefits until they are withdrawn. Self-dealing is when someone manipulates the retirement funds for their immediate benefit and this is strictly disallowed.

To avoid self-dealing, the new 401(k) needs to be managed by a separate fiduciary. A lot of consultants setup these kinds of 401(k) programs; however, it is difficult to find one that has the fiduciary capabilities to prevent self-dealing. We chose the Entrepreneur Retirement Plan of America (ERPA) to create and maintain the new 401(k). Now these funds were also available to the buyer for investment purposes.

It's important to point out here that this is not a loan. ERPA becomes a shareholder in the C Corporation and must be treated fairly like any other investor. If ERPA holds 100% of the stock, it receives 100% of the dividends. While this means those dividends go into ERPA without tax consequences, that much current cash is not available to the buyer. Many buyers end up buying back the stock from their ERPA accounts over time.

We now had the buyer's savings, home equity, and retirement funds and it still wasn't enough. Having exhausted the buyer's personal collateral, we next looked to see what we could get from the seller.

Supposedly there are many reasons a seller wants to sell; however, most of them translate to burn-out. They are just tired of their situation. A buyer's advocate who realizes this fact can often inspire the seller with a vision of a better future. In this case, the seller really loved his craft; he just hated running a business. The buyer was an expert at managing this type of business; but not a technologist. We saw a marriage.

Since the ERPA plan already required a C Corporation, we used another benefit of C Corporations to further interest the seller in becoming a partner. The seller would be taxed on the gain of the sale of his business. It's not a straightforward tax. Different aspects of the business are taxed differently. Depreciated tangible assets are subject to depreciation recapture that is taxed at as Ordinary (read highest tax rate) Income. Goodwill is taxed as a Capital Gain, which has lower rates for individuals.

Our proposal was that the seller receive cash for his Goodwill and exchange his depreciated assets for stock in the new C Corporation. We recommended this exchange be done as a Section 351 transfer, one of those C Corporation benefits that allows someone to exchange assets for stock in a non-taxable event. Only the Goodwill would be taxed; and that at lowest rates.

As a shareholder in the new corporation, the seller would be in charge of the technical side of the business, leaving all the managerial and administrative concerns with the buyer. He would receive tax-advantaged cash now, and a future income for a business that would become much larger than the one he was selling.

The total value for the enterprise would be worth the funds the buyer had in savings and his HELOC, then the investment from the ERPA plan (another stockholder), and finally the fair market value of the assets involved in the 351 exchange. It turned out that they were all about the same, making each one about a one-third owner of the new business. The buyer was given voting right for the ERPA stock and therefore had majority control; however, a stock purchase agreement clearly defined how all decisions in the new business would be made, protecting the seller's interests.

When the seller told his wife about his decision to accept this proposal, he told her he felt like he had been in a boat without oars and now his new "partner" was finally bringing the oars. It's a lot of math; but still an emotional decision.

However, our money problems still weren't over. All the available cash after closing would be in the seller's bank account. There was no working capital left over. We next approached a local lender who was willing to grant the new business a line of credit collateralized by the value of the fixed assets the seller had exchanged into the new business. Another aspect of the C Corporation is that banks frequently see them as more "substantial" and they are generally more open to non-SBA lending.

Conclusion

This deal took months. It needed time for the buyer - seller relationship to develop. We have found that once any deal hits the point where the buyer and seller have respect for each other, all the transaction advisor needs to do is show them solutions. They will then make the deal happen. They also started using the fact they were the only HVAC company with a 401(k) in the area to attract the best techs.

The lender who knew an SBA loan would not work here also took notice of what we did. They had always realized a loan on the deal was good business and they were originally frustrated they couldn't make one. Impressed with our efforts, they began to look at ways they could make working with SBA loans easier.

Our next deal involved a critical closing date and the SBA paperwork was not completed on the critical day. That lender didn't roll-over and let the deal die. They put together bridge financing for us until the formal SBA guarantee arrived. Creativity among partners can be contagious.

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