

FOR EXECUTIVES SEEKING TO BUY, SELL, OR RECAPITALIZE BUSINESSES

C-Corp: A Business Seller's Nightmare

The Horror of C-Corp Asset Sale

"I'm proud of paying taxes. The only thing is--I could be just as proud for half the money." – Arthur Godfrey

We recently completed the sale of a healthcare deal where the seller had his business incorporated as a C-Corporation. When we informed him of the downside of a C-Corp in an asset sale, the business owner was stunned. While C-Corp business sale has no disadvantages when it comes to a stock sale, the tax burden on the asset sale of a C-Corp can be onerous to a business owner.

To begin with, C-Corp shareholders suffer from double taxation. All corporate income is taxed at the corporate level and any distributions of the profits to shareholders in the form of dividends are taxed at the shareholders personal level. For most mid-market businesses in California, the gains at the corporate level are taxed at the corporate tax rate of 42.84% (34% federal and 8.84% CA State). Further compounding the problem is the fact that there is no such thing as Capital Gains for C-Corps. All income, including income on properties held on a long term basis, is taxed at the same rate.

Assuming an asset sale, which is the preferred type of sale for most acquirers, and worst case allocations, the seller is looking at a potential tax liability of 42.84% at the corporate level and a further 44.3% tax liability at the personal level (35% Federal and 9.3% CA State) leaving him with an effective tax rate of about 68% of the gains on the transaction price! Ouch!!

The worst case scenario for an S-Corp asset sale is far superior. The seller only needs to pay 1.5% at the Corporate level (0% Federal and 1.5% CA State) and a further 44.3% at the personal level. The difference in sale proceeds from a C-Corp and an S-Corp amounts to 22% of the gains in this worst case allocation scenario. On a \$10M transaction gain, that boils down to \$2.2M!

This above scenario is the worst case and with more reasonable allocations and with some creativity in deal making, this difference can be narrowed significantly. However, even in highly optimistic allocation scenarios, sellers are looking at about a 15% difference in take home just because they chose a wrong corporate structure!

In the case of our healthcare business owner, we could locate a buyer who was willing to do a stock sale and we were able to put together a dramatically better deal for the seller with a 24.3% tax bite (15% Federal Capital Gains Tax and 9.3% CA State). That's about a **44%**

savings on taxes compared to the worst case asset sale scenario! We were pleased with how well we could serve this client, but not all stories end so well.

If you are a business owner with a C-Corp, here are some options to help avoid the nightmare at exit:

1. Unless there is a compelling reason to remain as a C-Corp, switch to an S-Corp. Note that there is a 10 year recapture period before the conversion is complete. Consult your CPA or M&A advisor for advice on steps that you need to take if you plan to sell the business within the 10 year window.
2. Consider moving or retaining the ownership of all appreciating assets outside of the C-Corp into a different entity such as an S-Corp or an LLC.
3. For all future incorporations, avoid a C-Corp structure altogether unless there is a very compelling reason to be a C-Corp (ex: having plans to go public or having a lot of shareholders).
4. If you have a C-Corp, for all practical purposes, you must aim for a stock sale. Look for an M&A advisor who is experienced in doing stock deals. Anecdotally, about 1% of the small to mid-market business intermediaries have the proper experience to do stock sales.

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