Selling a Business Without a Lender

By Robert W. Olson Jr.

Given recent events, institutional lenders have tightened their underwriting requirements and increased interest rates for prospective buyers of small businesses. That situation isn't going away soon, and that puts prospective sellers in a difficult position. This is particularly true if the seller needs to sell quickly and the buyer doesn't have sufficient cash to buy the purchase price. If the buyer doesn't have sufficient cash or institutional lending sources to complete the purchase, the seller may have to consider one or a combination of the following alternatives.

Non-Institutional Buyer Financing. The buyer may have home equity to borrow against, or family members that can lend toward the purchase. The seller should always ask if either of these sources is available for the purchase price, before suggesting any of the below payment options.

Buyer Earn-In (Sweat Equity). If the seller is willing to stay on a while as a co-owner, the buyer can earn their way into full ownership by taking less pay than they would as an owner, with seller banking the excess for annual (or more frequent) payments, until the full purchase price is paid. From a tax perspective, it's crucial that the seller pay the buyer that banked excess as compensation, with the buyer paying most of that money back to the seller as a partial purchase price, with that back-and-forth transaction documented in writing. If not completed in this manner, and the parties just transfer a portion of the business without this formality, both parties will end up owing about twice as much in taxes than had they followed the recommended procedure.[1]

Buyer Earn-Out (Share of Post-Sale Receipts). If the seller is unwilling to stay as a co-owner, or the buyer is unwilling to pay a fixed price due to concerns about post-sale business income, the seller can accept a certain percentage of the business' post-sale (gross) receipts as payment. For example, if the purchase price would have been 75% of the business' annual receipts, a typical arrangement would be for the buyer to pay the seller 25% of the business' receipts monthly over the first 3 years post-sale.


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This approach works well when the seller stays on as a co-owner, the business caters primarily to other businesses, or almost all customer payments are by credit card and electronic fund transfers that are reported to the IRS. Otherwise, this approach has significant downside risks. The seller who is no longer a co-owner leaves the buyer the ability to hide some of the business' cash flow. Also, businesses that cater to non-business customers risk significant underpayment, since those customers are not required to report their purchases of $600 or more to the IRS, and cash or check payments may never hit the buyer's bank account.

A partial solution is for the seller to retain audit rights, to confirm the buyer's financial, sale and tax records over the applicable payment period. Also, the seller should never accept a percentage of "net" income or similar metric, since it is too easy for the buyer to reduce its net income with other forms of creative accounting.

Seller Financing. Institutional lenders have long-term experience, large underwriting and legal departments, and substantial loan portfolios, that reduce the lenders' overall risk of loss. The seller doesn't have the same ability to protect itself as does the institutional lender. Therefore, I view seller financing as an undesirable option. It only becomes acceptable when (a) the buyer can't get an institutional, family or home equity loan to pay the entire purchase price, and (b) the seller has to sell within a very short time period.

Precautions. A full cash buyout is almost always preferable to any form of financing. While there are tax advantages to using an "installment sale" to take payments over time, that approach tends to add an unacceptable level of risk that the purchase price won't be paid at all, especially if the seller is no longer actively involved in the business.[2] Therefore, if the seller needs to sell quickly, there may be no choice but to accept a Buyer Earn-Out or Seller Financing. In those cases, I strongly suggest that proper precautions are taken before finalizing that sale. These precautions include the following:

Investigate the Buyer. The seller needs to investigate out the buyer's financial status, business experience, and general reputation. A financial statement signed under penalty of perjury, state and county lien checks, confirmation of corporate and licensing status (as applicable), and a review of social media, on the buyer are required to help assure that the buyer is an acceptable credit risk.

Get a Substantial Down Payment. It's much harder for the buyer to walk away from a business if doing so sacrifices their own initial investment in the business. 20% or more is preferred, but even the greater of 5% or $10,000 of the purchase price will help motivate the buyer to keep working the business, and keep making payments on its seller financing.

Get it in Writing. This should be obvious, but some people need to be reminded that, in a dispute, they can't prove the content of their agreement without a comprehensive written contract.

Record a 1st Position Lien. A security agreement, and a lien recorded with the Secretary of State and the County Recorder, creates a public record of that security interest and that a lien exists on the business assets. A pre-closing investigation of the buyer should show no pre-existing liens that would attach to the purchased business, since those liens would be superior to the seller's lien. If the seller has a 1st position lien, the buyer cannot sell the business or obtain other loans without paying off the seller's 1st position lien. If the buyer fails to pay the seller as required, the seller then can take back the business and retain all payments previously made on its loan.

Recalculate "No Interest" Loans. Many installment sales attempt to set the buyer's post-sale loan payments at a fixed amount per month at 0% interest. With certain exceptions, this approach is considered a "below market loan" with an "original issue discount" under state and federal tax law.[3,4] As such, the seller is required to declare a minimum portion of their payments as interest income, and the buyer is entitled to deduct that same amount of interest income, based on the "applicable Federal rate" of interest ("AFR").[5] It's easy to reverse engineer the loan principal, using the minimum AFR with a financial calculator, to fix this tax issue.

Get a Personal Guaranty. Corporations and LLCs can declare bankruptcy and leave the seller with no recourse at all. A personal guaranty is almost always a non-negotiable seller requirement.

Include a Reverse Non-Compete Agreement. Most business sale contracts require the seller to not compete with the buyer within the business' geographic area for a number of years. If the buyer fails to pay the loan and the seller takes the business back, the business isn't worth anything if the buyer just opens up the same type of business in the same area, and then siphons off all the customers that gave the original business its value. Therefore, the contract should include a "reverse" non-compete agreement on the buyer, if the buyer breaches its payment or other obligations under the contract, and the business needs to be taken back or sold to another buyer. ■

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Endnotes

1 For details, please see my January 2021 article in Santa Barbara Lawyer, "Tax Ramifications of Sweat Equity in Professional Partnerships."
2 26 United States Code §453 and IRS Form 6252.
3 26 United States Code §7872.
4 18 California Code of Regulations §24271(e)(3); applies to California corporate sellers only.
5 26 United States Code §7872(e)(1)(A). The AFR is set monthly for short term, mid-term and long -term loans and can be found at https://www.irs.gov/applicable-federal-rates.