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With four specific services, The Center provides complete unbiased planning. The Center does not sell any products; its main purpose is to provide advice. Local experts are retained to implement the plans developed by the Center. The Center for Financial, Legal & Tax Planning is located at 4501 W. DeYoung Street, Suite 200, Marion, Illinois 62959. Phone 618-997-3436; Fax 618-997-8370.

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Rising Interest Rates Mean Opportunities For Owner Financing

All of your life, you have worked hard, made sacrifices, and built the business which you own. Right now, you may be wondering what the next step is. Our advice, don't let an entire life of hard work disappear! The fact of the matter is that most businesses have a value that the owner can base his or her retirement.

As the first baby boomers turned 60 in January 2006, business sales have become more and more prevalent. Business owners work hard, concentrate on the day to day operations, enjoy the income, dread the losses, but rarely have any thoughts as to what will happen in the end. As such, these same business owners now realize 1) it will be difficult to find a qualified buyer who can get bank financing quickly, 2) it will be difficult to get the kind of money they want for the business, and 3) the taxes are probably going to be substantial. With rising interest rates, financing is becoming increasingly hard for buyers to find at an affordable rate. The solution to the problem, an installment sale via owner financing.

An installment sale is a sale where at least one payment will be received in the next year. Owner financed installment sales are useful in situations where the buyer cannot get bank financing quickly or sometimes not at all. They also have the effect of reducing the tax liability by breaking the transaction into multiple payments as opposed to one giant lump sum. Additionally, there are also more advantages available due to the flexibility that installment sales offer that standard bank financing cannot offer. This article will discuss the pros of selling your business under terms of an owner financed installment sale.

Sell Faster

Many people are familiar with the process of applying for a home loan. Applying for a home loan can be a very tedious and time consuming process. During the process, the home buyer's credit is checked, they are sized up by the lender, financial statements and tax statements usually have to be presented in order to prove their worth or income. The same holds true for business buyers.

Under standard bank financing, buyers must meet standards that their lending bank imposes regarding credit and net worth in order to get a loan. In the case of purchasing a business, banks will even go further, requiring yet even more proof of net worth, income, credit, business experience, assets being purchased, etc…. In fact, some lenders will not approve the purchase of certain intangibles with their money. For instance, purchasing goodwill is generally not allowed under some standard financing lender's policies. It can be a very time consuming process for the buyer. Ultimately, the final decision on the loan papers can be in bold print, "DENIED" rendering an entire process of applying for a loan worthless. Because most banks use similar standards, if the loan application is denied by one bank, it is likely that the buyer will not be able to purchase the business under standard bank financing.

However, if the same buyer-seller can decide on an installment sale for the sale/purchase of the business, the process can go much faster and smoother. Typically, bank institutions must conform to certain rules and regulations regarding their loans to conform with FDIC rules and general rules regarding banking, hence all the red tape. With owner financed installment sales, the bank rules do not apply. Sellers can hasten the process to go much faster and can approve the buyer in days as opposed to weeks.

Choice of Buyers

Another advantage with owner financing is that sellers can be as choosy or as lenient as they want when approving a buyer's credit. A buyer who would not qualify for a bank loan may be an appealing buyer to a seller for different reasons. For example, many buyers would be successful business people and entrepreneurs. They perform poorly in the role of employee and general consumer; however, in the business world their risk tolerance makes them capable to effectively run a business successfully. In fact, a very successful real estate guru, who has his own television show, has filed bankruptcy multiple times. From a credit standpoint, the man is a terrible credit risk. As a business person, banks are willing to lend him money.

The same can be true for many business buyers. Their credit can be extremely poor, because their risk tolerance is high and they may have failed in some financial situations. The same person can thrive in a business and become very successful given the proper niche.

Of course, this is not to say any risk taker is an excellent investment, nor is it to say that you should sell your business to a person with poor credit. In the case of people with poor credit, the risks of the seller's loss can be hedged with use of certain legal documents, strategies, and protocol that will reduce the risk to an acceptable level.

There is also the buyer who lacks net worth. Banks will typically require that individuals wanting a loan to have a certain net worth. Sellers, willing to finance the sale, again are not subject to bank rules. Merely because a buyer has a net worth of $1 million, does not mean he or she should be able to run a business worth $3 million.

Therefore, the freedom to choose the buyer is an important aspect of a business sale. Banks are not always well prepared to assess the buyer from a third party standpoint when it comes to competence in running a business. Often times, a seller or a representative can measure the caliber of the buyer and decide what action to take. Of course, the seller bears the risk, but bigger rewards can follow.

> ***Business sellers face a plethora of taxes when they sell their businesses, especially in an asset sale.***

More Money

There are three reasons why you will get more money for seller financing as opposed to bank financing. Generally, bank loan limits, interest income and risk factors contribute to sellers getting more for their businesses under owner financing than under standard bank financing.

Banks are only willing to give buyers so much money based upon the financial factors. A buyer wanting to purchase a $5 million dollar business may only qualify for a $4 million loan. Sellers are not bound by the same factors and may allow the same individual to borrow much more money in a higher sales price for the business.

Second, lenders always get interest on their loans. A 30-year $100,000 loan at 8% will gross the lender $264,154 in interest and principle. If a buyer chooses a bank lender, the lender will get paid $164,154 in interest. Had the same buyer been obligated with a seller installment agreement, the seller would be paid a grand total of $264,154 for the same business which would have only grossed $100,000 in a bank financed sale. In each loan instance, the installment agreement would net the seller more money for the seller financing the sale.

Third, sellers can impute a risk factor into the loan. Since standard lenders are not willing to make the loan in all instances, a premium for risk can be assigned either to the principle or interest of the loan made by the seller of a company. The extra interest principle can be substantial depending on the interest premium charged.

Less Taxes

Business sellers face a plethora of taxes when they sell their businesses, especially in an asset sale. When selling assets, business owners pay both recapture taxes and capital gains taxes. Recapture results when depreciated assets are sold. The tax rate is ordinary income on the gain to the extent of depreciation taken. Beyond the purchase price of the assets, sellers can expect to pay capital gains taxes, which are generally taxed at 15%. Because the gains are taxed in one year, in a standard finance agreement, sellers can expect to pay much higher taxes.

The same sale in an installment sale would result in a spreading of the gains over a period of years resulting in less taxes resulting from the ability to use the lower tax brackets.

To illustrate, a taxpayer in 2006, selling his or her business for a gain of $1,000,000 ($200,000 recapture and $800,000 capital gain), can write the installment payments to last ten years. Instead of taking the entire gain in 2006, the arrangement would result in a $200,000 recapture gain and $80,000 capital gain in year one, followed by $80,000 in capital gain for the remaining 9 years. The lump sum would result in taxes of approximately $200,000. Had the same taxpayer elected or sold under owner financing, the taxes paid (disregarding interest income tax) could be cut to approximately $134,000 over a 10 year time frame. This is a savings of $66,000 over ten years.

Conclusion

The Federal Reserve, banks, and other lenders are all in agreement that interest rates are set to rise. Rising interest rates can result in lower selling prices for homes and businesses alike. The rising rates can also mean no sale at all for business sellers. With owner financing, business sellers can overcome this dilemma and gain even more from an owner based finance arrangement.

Some sellers are put off by the concept of owner financing. This should not be the case, as hybrid methods of owner financing and bank financing can also be reached. If you are willing to sell and can find a willing buyer, there is always a way to reach a reasonable agreement that both buyer and seller will find satisfactory. The Center routinely deals with business sales that are from 100% bank financing to 100% owner financing. If you are involved in an adverse finance situation or are having difficulties reaching an agreement, please contact The Center for assistance. Work with the "deal structuring" professionals to close the sale.