Anchin, Block & Anchin LLP
Accountants and Advisors

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Avoiding Double Taxation from Selling a C-Corp – Not Easy but Possible

When the owner of a C-Corporation sells their business for a profit, the profits will be taxed twice: once at the corporate level and again when money is distributed to the owner/shareholders as a dividend. However, in some circumstances there may be a way to avoid the double taxation. It's a difficult strategy to pull off but could be possible under the right conditions.

C-Corp Double Taxation

Let's say a business owner has a C-Corp with physical assets worth $10 million and someone agrees to buy the company for $20 million. Let's assume the tax basis of the assets is also $10 million. The buyer may be willing to pay more than the value of the physical assets because of goodwill: intangible assets like the company brand, client relationships and current employees. How would the taxes work on this $10 million gain?

First, the C-Corp would owe the corporate tax rate of 21 percent on the gain. After the corporate taxes are paid, the owner will receive whatever's left as a dividend and owe personal income taxes on that dividend. They will owe up to another 23.8 percent tax on the dividend payment (up to 20 percent from the maximum dividend tax rate and another 3.8 percent from the Net Investment Income Tax.)

While the owner could try to avoid double taxation by structuring the deal as a stock sale rather than an asset sale, this is less attractive for the buyer because they will not receive a step-up in basis for the assets acquired. Chances are, they will lower their price for an offer for a stock sale, which would cancel out the benefit from avoiding double taxation.

Personal Goodwill

Another way to avoid the double taxation is by identifying some of the goodwill as personal rather than enterprise. This means the goodwill comes from the owner's personal contributions rather than from the business itself. For example, from the owner's direct relationships with clients, unique technical expertise and their own business reputation that is separate from the company.

When the buyer pays for personal goodwill, it's only taxed once at the personal level and not at the corporate level. In the example above, if the business owner can split the $10 million of goodwill equally between enterprise and personal, they will avoid paying the corporate tax on $5 million. Assuming they would have paid the corporate tax rate of 21 percent, that's $1.05 million in tax savings from this strategy.

The buyer also receives the same step-up in basis as a regular asset sale so they should not lower their offer should the owner use this approach.

Exercise Caution

Business owners should know that this strategy is difficult to execute successfully. The IRS has very strict standards for personal goodwill and aggressively disallows this approach under the wrong circumstances. Some of the requirements for this strategy include:

- Everything was documented clearly from the start. At the very beginning of the sale, the business owner should be identifying personal versus enterprise goodwill as they negotiate terms with the buyer. It can't come in after the fact as the seller tries to minimize taxes.
- The seller cannot have a noncompete clause with the business before the sale.
- Before the sale is completed, there must be an appraisal of the business supporting the valuation of personal goodwill versus the other business assets.

This strategy tends to work better with physicians, law firms or similar types of businesses where it's easier to value the personal contribution of the selling owner/partner. It also makes more sense for bigger companies realizing a larger profit from the sale. For smaller companies it may not be worth the hassle, especially since the Tax Cuts and Jobs Act of 2017 lowered the maximum corporate tax rate from 35 percent to 21 percent.

Any business owner considering this strategy should consult with a tax specialist as early as possible in the sales process. That way they can decide whether it's appropriate and if so, start documenting everything properly so they can prevent a future IRS challenge.

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