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Tax and Financial Newsletter from "The Power of the Dual View"

This ***Tax and Financial Newsletter*** *discusses the legal, practical and tax aspects of acquiring, selling or starting a business. It can be used as a tool for creating an owner's checklist for issues to consider. It concludes with the basic legal documents and tax steps in a buy/sell transaction.*

INTRODUCTION TO ACQUIRING, SELLING, OR STARTING A BUSINESS

Acquiring, selling, or starting a business is one of the most exciting events for entrepreneurs. Many hours, and possibly years of thought have gone into the decision. Numerous questions have been asked and analyzed. Is this the right time for my organization or me? Is the price fair? Can I afford to sell? Will the business make sufficient profits? Is the person I am dealing with trustworthy? What are the tax consequences? Should I operate as a S-corporation or limited liability company? The questions are numerous and the answers are not always certain. To reduce that uncertainty though, a checklist can help. The next section is a template for the Seller's starting point.

STARTING CHECKLIST FOR SELLERS

- ✓ What are my due diligence procedures to perform to determine a fair price?
- ✓ Are my financial statements current and accurate?
- ✓ Should or will any earnout (post-closing performance payments), escrowing back money, or contingency payments be part of the purchase price?
- ✓ If the purchase price is financed, what is the appropriate collateral, and is a personal guarantee required?
- ✓ Should or will part of the purchase price include a covenant-not-to-complete or consulting agreement?
- ✓ Will the purchaser desire to retain key-employees and if so, on what terms and conditions?
- ✓ Are there any assets the seller will want to retain or liabilities the purchaser will require the seller to assume?
- ✓ What are the representations and warranties a purchaser will want from the seller, and what are the reps and warranties the seller desires?
- ✓ What should be included in the Non-Disclosure Agreement (NDA)?
- ✓ See page three for income tax aspects for purchasers and sellers to consider.

DUE DILIGENCE CHECKLIST FOR PURCHASERS

1. Have we accurately ascertained why the seller desires to sell?
2. What should be included in the terms and conditions of the letter of intent (LOI)?
3. What difference will it make if stock or membership units are purchased instead of assets?
4. Have I properly analyzed the balance sheets and income statements, including gross profit margins, net income or loss margins, year-to-year sales and expenses?
5. How does the purchaser determine if the company's assets and sales are accurately stated on its financial statements?
6. Are there any "unanticipated" declines in revenues or sales around the corner?

7. What assets exist that are not reflected on the balance sheet and what assets are on the balance sheet that are not worth the stated book value?
8. How have you determined there are not any unrecorded debts or liabilities?
9. Are all taxes current including payroll, income, sales (including purchase price sales taxes), and property taxes?
10. Is there any potential litigation or disputes with vendors, customers or employees?
11. How do I find out if any problems exist with the land, buildings, or leases?
12. Is the existing workforce stable and how will they react with a new owner?
13. Are there any key employees who must be "sold" with the business and retained?
14. Are there any problems with the contracts that I am purchasing; are they assumable?
15. The next section is also applicable to purchasers and for starting a business.

CHECKLIST FOR STARTING A NEW BUSINESS

- ✓ How can I obtain the least expensive financing? The typical sources are seller-finance, investors, personal money and assets, or bank and SBA financing.
- ✓ What is the plan for developing, implementing, and operating the accounting system?
- ✓ Am I properly coordinating my personal and business taxes to pay the lowest income taxes possible?
- ✓ Do I know the basic Federal and State income tax rules that apply to my business?
- ✓ What employee benefit programs should I implement currently and in the future?
- ✓ Does the business have a good employee manual? What should be in the manual?
- ✓ If I have partners, what provisions should be in the operating or shareholder agreements?
- ✓ Should the partners enter into a buy-sell agreement and what provisions should be in the agreement?
- ✓ What is the plan if a partner or owner becomes disabled or passes away?
- ✓ Does my personal estate plan properly consider the business?

DOES THE BUSINESS PLAN INCLUDE THE FOLLOWING?

1. Statement of organization and objectives.
2. Identify products and services.
3. Marketing plan and strategy.
4. Identify competitors and how the business will successfully compete with them.
5. What is the backup plan?
6. See below for cash flow projections.

HAVE CASH FLOW ANALYSIS AND PROJECTIONS BEEN COMPLETED?

1. Typically, the more detailed cash flow projections are, the better. Avoid lumping expenses in one category as detailing expenditures can trigger other thoughts.
2. Generally, a three-year projection is the minimum.
3. How much cash must be generated to service any purchase money debt?
4. Can the business generate a reasonable return for the owners?
5. Is there sufficient cash flow to replace obsolete and worn out equipment?

6. Have all taxes been accounted for including income, payroll, property, and sales?
7. Does the cash analysis take into consideration the differences that will exist for a new owner?
8. Has enough "cushion" been established for unforeseen expenditures and problems?
9. What is the cash flow breakeven point?

INCOME TAX ASPECTS FOR PURCHASERS AND SELLERS

The income taxes for buying or selling a business are complex. Taxes are likely the seller's largest expense. Initially a purchaser's taxes are not as significant, but will add up over time. The good news is business taxes right now are favorable for both acquisitions and sales. This section highlights the major tax issues for both parties.

- Capital gains rates are 20% maximum, and many times business sales are not subject to the 3.8% net investment income tax.
- Most business income enjoys a 20% business income deduction, a good benefit if seller has to recognize ordinary income.
- Many newly purchased business assets can be written off 100% in the year of acquisition.
- Goodwill and other intangible assets, although usually capital gain for the seller, are amortized over 15 years for the buyer.
- Oklahoma provides a capital gain exclusion if the business is held long enough and operates in the state.
- Oklahoma allows partnerships and S-corps to pay the OK taxes on its income; and that usually reduces federal and state taxes.

⇒ A buyer usually desires to ***acquire the assets*** of a business because that limits transferee liability and acquired assets can be depreciated or amortized. Stock cannot.

⇒ Sellers generally ***prefer to sell stock*** to avoid or avoid double taxation issues, ordinary income recapture, as well as limiting transferor liability.

⇒ In many asset sales, the seller has capital gains, capital losses, and ordinary income. If the three are not properly coordinated, taxes will increase.

⇒ In larger acquisitions it is common for the parties to legally perfect a stock sale and elect asset sale tax treatment. Typically the seller's taxes increase due to ordinary income recapture, but the purchaser's taxes usually decrease by more because the acquired assets can be written-off.

⇒ If assets are sold, the purchase price needs to be allocated among the assets. The purchaser generally desires to have the price allocated to shorter life assets (equipment, inventory, etc.), while the seller typically prefers allocations to goodwill and other intangibles.

⇒ There are situations that for tax purposes the asset allocation does not matter to one party; exploit those situations for the benefit of both parties.

Tax Tip! Purchase price negotiations can sometimes be resolved with an asset allocation which is favorable to one party and a non-issue to the other.

⇒ A covenant-not-to-compete is ordinary income to the seller in the year cash is received and amortized over 15 years for the purchaser.

⇒ If a seller-financed transaction, a tax efficient model can be: (1) down payment equal to and for the inventory or accounts receivable; (2) instead of selling, lease the depreciable assets over the remaining useful lives; and (3) a note payable for the goodwill or other intangibles.

⇒ When financing the purchase price for corporation stock, it may be more advantageous for the corporation to redeem its stock and the new owner purchase a few shares.

⇒ Be aware that employment taxes are incurred with consulting agreements and are ordinary income to the seller, but generate a current year tax deduction for the purchaser.

⇒ When a C corporation sells assets and then distributes proceeds to stockholders, double taxation issues exist.

⇒ An installment sale can be an excellent opportunity for tax savings or tax deferment.

THE BASIC LEGAL & TAX STEPS IN AN ACQUISITION-SALE

1. The buyer and seller's first legal step is usually a non-disclosure agreement.

2. The seller typically has a price range in mind and starts calculating or hires a CPA to determine "what are the taxes due?"

3. If the parties desire to proceed further, then a Letter of Intent (LOI) is generally entered into outlining the "dicker terms."

4. The parties then direct their legal teams to start working an Asset Purchase or Acquisition Agreement (APA).

5. If a stock sale, the tax election to treat it as an asset sale is analyzed.

6. The asset allocation should start taking shape at this point. Sometimes an independent study is employed.

7. The detail terms of the Non-Competition Agreement are worked.

8. The typical agreements referenced in an APA for seller financing are:

   a. The security agreement including, what is the collateral? A real estate mortgage is a type of security agreement.

   b. A personal guarantee that can also include specific personal assets will be collateral.

   c. A Promissory Note, with the interest rate, duration, and default provisions.

   d. Conveyance documents generally include Bill of Sales, General Assignments, Deeds, Title Changes, etc.

CONCLUSION

We have represented clients in transactions ranging from five to nine figures, including start-ups, acquisitions, and sales. The concepts and statements herein are an accumulation of the "entrepreneur issues" we typically encounter. Thus, we also use this Newsletter as a beginning point for our legal, tax, and accounting checklist to help our clients efficiently close their transactions.

Tax Tip! Efficient tax planning for selling, acquiring, or operating a business starts with proper entity selection and operations thereunder. Our Newsletter, "L.L.C., S-corporation or C?" provides over 40 tax tips, comments and circumstances for entity selection considerations. Visit our website Paulhburgess.com for that Newsletter.