

Tax Strategy for Selling a Privately Held Company

The economic recovery apparently has started, setting the stage for industry consolidation, mergers, and acquisitions. Company cash is earning little interest, stock prices are rising, and profits are returning. The feeding frenzy on closely held companies comes next.

Buying companies will be offering cash, asset purchases, so-called tax-free deals, mergers, and many other variations. Here are some tax related strategies to maximize a closely held target's valuation. These suggestions go against the grain of conventional tax planning wisdom - but if they are implemented now with an anticipated sale within two years, your closely held client may avoid very costly mistakes.

The biggest tax mistake of all is not understanding the buyer's valuation formula. An owner may think the real value in her company is her wonderful employees, or her great reputation, or her longevity in the marketplace. The financial analysts, however, will be looking at the company's EBITDA: Earnings Before Interest, Taxes, Depreciation, and Amortization.

After the analysts compute EBITDA they apply a multiplier factor they think is appropriate for the company's industry, with adjustments for what they might see as the company's growth potential - or lack thereof. Multipliers typically range from four to nine times EBITDA.



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EBITDA is not always the sole basis for the valuation. Sometimes the formula or rule of thumb is a multiple of sales. Nevertheless, EBITDA is still taken into consideration by sophisticated buyers.

Note that income taxes are not deducted from earnings in the EBITDA approach. Tax planning strategies are designed to reduce earnings so fewer taxes are due. Beware: your client's careful tax planning may now become its worst enemy.

For example, a company with current tax planning in place has EBITDA of \$1 million per year. If the appropriate multiplier is assumed to be seven, then the indicated value is \$7 million. (This may be adjusted to deduct long-term debt and add back free cash.)

Now, assume no tax planning deductions. The company's taxable income goes up by \$500,000. The EBITDA is before taxes and increases to \$1.5 million, and the valuation jumps to \$10.5 million (1.5 times seven). This results in an increase of \$3.5 million just by paying the additional income taxes on \$500,000 - which are about \$200,000.

The following are tax planning mistakes that should be avoided in the year or two before the business is sold. Some of this can be done at the last minute with *pro forma* financial statements, but having an actual track record is more persuasive. The sooner the company gets started, the better.

Too much family compensation: This may be a good time for an owner to take a big pay cut and take relatives off the payroll or reduce their compensation. Another strategy is to reduce relatives' pay to minimum wage, retaining their health insurance, and lend them living expenses. A company might stop providing company assets for personal or family use, even if those expenses are being properly charged on W-2 forms. An owner should consider forfeiting reimbursement of business expenses and changing the employment agreement to reflect his or her obligation to pay certain expenses individually.

If a target company's owner cuts his \$250,000 annual salary to

\$100,000, this not only increases earnings but it greatly decreases payroll taxes and fringe benefit expenses. If the acquiring company wants the target's owner to stay on as manager, negotiate for a significant salary increase and additional fringe benefits - after the valuation has been set. Sometimes, sophisticated buyers will reduce the EBITDA by the additional compensation they figure they will have to pay to replace underpaid employees - but let them figure this out.

As noted above, if a company can reduce the compensation of other family members so as to increase EBITDA by \$500,000, this translates into an increase of \$3.5 million in valuation: significantly more than the \$200,000 in additional income taxes the company may have to pay.

Non-essential expenses - cut, cut, cut: Because every dollar of additional expense can reduce the valuation of the target company by a factor, they should be eliminated or deferred. A good time to start scrubbing through expenses is a year or two prior to sale. A company should scrutinize consulting expenses, fees paid to outside service providers, R&D, maintenance and repairs, fringe benefits, etc. Consider all operating expenses, even such basics as utilities and shipping.

While a company should not overpay anyone, it absolutely should not make the mistake of underpaying key employees or the sales department. Keep customers happy and sales strong.

Some closely held companies typically value ending inventory on a very conservative basis to avoid overstating taxable income. When anticipating a business sale, however, be more rigorous in counting inventory and making sure it is all on the books at full cost, including the allocation of overhead required by the tax code. The allocation of overhead to inventory increases taxable income and EBITDA.

Not considering operating expenses versus capital expenses: Generally speaking, capital expenditures funded by debt will not adversely affect EBITDA. Neither the interest on the debt nor the depreciation or amortization reduces EBITDA. On the other hand, operating expenses reduce EBITDA dollar-for-dollar.

An example of how an operating expense can be converted to a capital expense is changing a rented asset into an owned asset. Rent is a current operating expense. If a company buys the asset with borrowed money and then amortizes or depreciates the cost and pays interest on the debt, there is no reduction.

If a business needs a \$100,000 piece of equipment and can rent it for \$25,000 per year, the valuation of the company is decreased by \$175,000 (25 times seven). If the company instead borrows \$100,000, buys the equipment, pays \$7,000 in annual interest, and takes \$20,000 in annual depreciation, it will have zero impact on EBITDA.

The formula might require - but not always - a further reduction of equity value by the amount of additional debt. So while the value increases \$175,000, it will be less the \$100,000 for a net increase of \$75,000 - still not an insignificant amount. A business may want to make the rent versus buy decision on a case-by-case basis to compute the net increase in value.

Note that acquiring a company is usually a capital expenditure that does not hurt EBITDA, but may add substantial earnings. Also, remember that while the debt related to a capital expenditure will not reduce the EBITDA, it may reduce the net value of the company equity depending on the formula used.



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Thinking a tax-free deal is better than a taxable deal: A simple rule of thumb is that to the extent the buyer pays cash or assumes a company's debts, the target company will be taxed. For the transaction to be tax-free or partially tax free the buyer will give shares of its company stock. But, watch out for the strings attached to those shares, such as the inability to sell them for a long period of time. There may be no downside protection.

For example, a target company's owner might receive stock worth \$16 a share that by the time it can be sold is worth only half that. On the other hand, the shares could increase to \$30 per share.

Not asking for a last minute kicker: Kickers are things that add value to a target company and may be perceived as little additional cost to the buyer. Many of these kickers are tax deductible for the buyer and taxable to the seller.

Consider asking for an out-of-the money warrant for the right to purchase shares in the buyer's stock at some price above current market price. An out-of-the-money warrant may not be highly valued.

I participated in negotiations for the sale of a closely held company where just prior to close we asked for a warrant to purchase 500,000 shares of the acquiring company at \$30 per share when the shares were currently selling for \$25. The buyer considered this reasonable and granted the warrant. Within two years the stock was at \$50 per share and the seller made \$10 million.

Other kickers are employment contracts for the target's owner, a covenant not to compete, or a seat on board of directors of the acquiring company.

The strategies presented here have significant income tax consequences for your clients and need to be considered within the context of the particular situation with advice by a tax professional.

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