FOCUS ON MERGERS & ACQUISITIONS

Taxes, investing the windfall and how long to stay on-board

By MICHAEL JOYCE
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It's time to sell.

After years of hard work growing a business and ultimately creating an entity that is attractive to buyers, a business owner is faced with many decisions: how to be paid for the business, how to manage tax issues, how long to stay after the transition; and how to invest his or her windfall.

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Closing the chapter on a business can be an emotional time for the seller, so stepping back to carefully and rationally plan one's exit is time well spent.

When considering the best way for a business seller to be compensated for the sale of his business, the "bird in the hand" theory comes to mind. Being paid up-front, in cash, is often the best possible scenario.

In some cases, it is proposed that the seller be paid over time. If a seller accepts these terms and is paid out over five years, for example, he receives 20 percent annually but has given up all of the company's value in year one.

While that idea may have some tax advantages (spreading the tax liability out over time), a business seller may not want to run the risk of the purchaser possibly running the business into the ground and defaulting on the payment before being compensated for the full value of the business at the time of the sale.

Other business purchase agreements call for payment in stock or a combination of stock and cash. This also can be less-than-ideal since the business may lose value over time based on the management decisions of the new owners – thus potentially decreasing the value of the stock and effectively reducing the purchase price.

THE TAX MAN

Business sellers should also factor tax implications into their understanding of the sales price.

They cannot make plans for all of the proceeds from the sale – since the sale probably will be subject to a federal tax of 20 percent on investment income or long-term capital gains (with 3.07 percent in additional Pennsylvania state taxes).

One tax strategy for the philanthropically-oriented seller is to put some shares of the business, prior to the closing of the sale, into a donor-advised fund with a charity. This is a bit like having a mini-foundation and gives the seller a vehicle for making charitable contributions over time.

But remember, while a donor-advised fund helps reduce the seller's tax burden, it is not money that one can live on.

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FAIR SALARY

Since many business purchasers want the previous owner to stay on to help make the transition smooth, another factor the seller must consider is how long to stay on-board following the company's sale.

The seller undoubtedly will sign an employment contract specifying the expectations for job duties and length of stay. Noncompete and nonsolicitation clauses often are included in these contracts. The seller must ensure that the employment contract is fair.

Purchasers have been known to suggest lower compensation for the former owner with arguments such as, "We're paying you a premium for this company, so you should take a salary that is below market." The seller should be sure to be paid competitively based on comparisons in the industry.

DIVERSIFICATION

Another consideration for the business seller is what to do with the proceeds after the sale. Usually, the seller is going from having a fairly concentrated net worth, with company-specific risk (that is, in his or her own company), to a sudden windfall that is more liquid.

Business sellers should work with a qualified financial adviser to create a diversified portfolio. The seller's net worth will now be far more liquid and marketable than when the majority of it was tied up in one entity that was not particularly marketable.

A final thought. While some business sellers go on to start successful follow-up ventures, not all of them get another bite at the apple – at least not something as big.

Business sellers are well-advised to protect a significant portion of the proceeds of the sale of their company with conservative investments and a focus on capital preservation.

Michael Joyce, founder and president of JoycePayne Partners of Bethlehem and Richmond, Va., is responsible for overall investment strategy, management of investment portfolios and financial counseling services. He can be reached at mjoyce@joycepaynepartners.com.

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to make sure they align with the financial statements provided. Inquire as to whether all taxes have been filed and paid timely.

(2) Methods used to quantify expense adjustments and project future operating results.

After you consider historical and current data, it's time to look ahead. Take the time to closely examine future projections and recastings. Specifically, you should verify that expenses removed are in fact nonessential or nonrecurring, and then determine whether their removal will have a negative impact on current business operations.

Ask this question when reviewing the projected operating results: Is it sensible or realistic that this company would be this much more profitable down the road? It is important to make sure the projections are grounded in reality, and not too optimistic or out of sync with the current cost structure.

(3) Practicality of potential business synergies.

As any merger and acquisition professional will tell you, the heavy lifting occurs after the agreement is signed. Combining two companies is a monumental task, so it is important to gauge whether potential savings, benefits or synergies are realistic and reasonable.

This might seem like putting the cart before the horse, but considering ahead of time how things might play out post-acquisition from an operational standpoint can help prevent headaches down the road. For example, you should consider whether expectations are realistic for reductions in personnel and other operating expenses.

You also will be expanding your customer base through this transaction, so make sure the revenue expectations associated with that expansion are sound. Last but not least, don't forget to consider costs associated with the operational integration itself.

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With all big-ticket purchases, it is important to conduct research to ensure it is a good value.

In the case of a business acquisition, financial data analysis already will be part of the process, so why not take it one step further by applying these considerations?

This additional scrutiny and fact-finding can help buyers avoid confusion, overpayment or unpleasantness.

Paula K. Barrett is a partner in the business consulting services group for Reinsel Kuntz Lesher LLP (www.rklcpa.com) in Wyomissing. Specializing in business valuation and assistance with the acquisition or sale of closely held businesses, she can be reached at 610-376-1595.

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