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## Selling Your Business Could Become 'Taxing'

By Allen Stott

Many owners plan for the eventual sale of their business without fully appreciating the tax consequences. Insufficient tax planning can be especially costly in a business transfer.

There are three primary methods of transfer — stock-for-stock exchange, stock sale and asset sale. For purposes of brevity, we'll assume the entire business interest will be conveyed, either for cash or stock. Only gains recognized from the sale will be considered.

### Asset Sale

Most shareholders of private businesses sell the assets of their companies, rather than stock. A 1999 International Merger & Acquisition Professionals (IMAP) survey found 60% of member transactions were asset sales, with 40% done as stock transactions. In an asset transaction, two taxable events may occur.

- The selling corporation recognizes capital gains equal to the difference between the basis of the assets and the cash received on the sale.
- A second tax may be imposed if proceeds received are distributed by the corporation to shareholders as dividends, or if sales proceeds are distributed to the shareholder in liquidation of the corporate entity.

In addition, the selling corporation may be required to recapture as ordinary income certain previously deducted expenses such as investment tax credits.

There are ways to minimize the two-level tax, but they can be difficult to accomplish without shifting some built-in gains to the buyer. Theoretically, this would reduce the selling price of the assets. Practically, the deal may not be consummated once the parties discover the true tax ramifications of the transfer.

Often, the selling shareholders lessen the potential for a two-level tax by entering into a non-compete and/or consulting agreement with the buyer. In the same survey mentioned above, 58% of the sellers received consulting agreements and 76% agreed to non-compete restrictions.

### Stock-for-Stock Exchange

Historically, public companies have used their stock to acquire private companies. When the selling stockholders exchange their stock for stock of the acquiring corporation, the exchange may qualify as a tax-free exchange under Internal Revenue Code rules.

If so, the shareholders will avoid the immediate recognition of a capital gains tax. In general, the selling shareholder defers paying capital gains taxes until stock received from the acquiring corporation is sold. The stock of most private companies will not be attractive to sellers. Likewise, many shareholders are wary of receiving stock of public companies that are subject to a fluctuating market. It may also happen that the target company shareholders receive stock that cannot be freely traded for some period of time, normally one year.

## **Stock Sale**

The sale of stock is the simplest method of transferring ownership in a taxable transaction. Once the sale is completed, the selling shareholder is relieved of all the corporation's contingent liabilities (unless an indemnification warranty is given).

From a tax standpoint, if the seller holds the stock as a capital asset, he or she will recognize a capital gain equal to the difference between the basis of the stock and the cash received on the sale. However, most business transfers don't involve stock sales because the corporation's contingent liabilities follow the stock into the buyer's hand.

## **Sale Price**

Mid- and large-sized business, those with greater than \$10 million in annual sales, normally transfer stock as opposed to assets. Smaller businesses are more likely to be asset transactions. This is more of a legal issue than a valuation one, since it is the cash generating ability of the business that is valuable.

The value of most private companies can be ascertained by determining its cash flow and the risk associated with achieving the flow. Cash flow is a different concept than earnings. Public companies attempt to maximize earnings. Private companies try to maximize cash flow, while seeking to minimize reported earnings to minimize taxes.

Once cash flow is determined, a pricing multiple can be applied. Selecting a multiple is where the seller and buyer are most likely to disagree. A multiple of five means the buyer accepts a 20% return on investment ( $1 \text{ divided by } 5 = 20\%$ ). Some buyers have the ability to improve the future cash flow. These strategic buyers typically are corporations in the same or related line of business that can consolidate operations. A strategic buyer can have a 20% to 30% pricing advantage over an individual/financial buyer.

A business must have a certain size before it makes sense for a strategic buyer to be interested. For example, the 1999 IMAP pricing survey shows for companies with annual revenue between \$20 and \$50 million the median multiple was 7.4 times adjusted Earnings Before Interest and Taxes (EBIT), while the median multiple was only 5.4 times EBIT for companies with revenue under \$10 million.

Selling a business is a difficult proposition. Consider the tax consequences before the letter of intent stage. Before striking a deal to sell your business, have your merger and acquisition adviser work with your attorney and/or certified public accountant to check the potential tax impact.

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