

August/September 2003

## **When should the family business stay in the family?**

**Reducing taxes to maximize return on a sale**

**The benefits of thinking like a buyer**

**PLUS! 6 common seller mistakes**



**G.A. HERRERA & Co.**  
*Investment Bankers*

*a limited liability company*

*[www.herrera-co.com](http://www.herrera-co.com)*

1502 Augusta, Suite 260 ♦ Houston, Texas 77057  
(713) 978-6590 ♦ Fax (713) 978-6599

# Chart the Best Course

## Deciding To Keep or Sell a Family Business

After 20 years at the helm of the family business, Maite is considering selling the company next year. After all, her company has satisfactorily matured, and she believes the time may be right to put it on the market. But questions plague her. How can she be *sure* it's the right thing to do — for her, for family members active and inactive in the business, and for loyal nonfamily employees?



The answer, of course, depends on numerous factors, including the company's value and current market conditions. Maite has wisely chosen to take her time before divesting. That way, our fictional business owner can properly plan and — in conjunction with M&A experts — assess the most expeditious approach to her goal.

### Keeping It in the Family

First she considers keeping the business in the family. Her experienced team of M&A professionals analyzes her company's financial situation and market position, among other factors. Here are a few highlights:

**Valuation.** First, Maite obtains a business valuation. The value may well determine Maite's final decision and certainly drives the plan if she intends to keep the business. Then she must determine whether to transfer the business during her lifetime, on her death or on her husband's death. Of course, the company's value and Maite's plans interest numerous parties, including tax authorities and her family.

Let's say Maite decides to will the company helm to her spouse. No estate tax will be due then because of the marital deduction, but it will be due on her husband's death. But Maite and her spouse might want the value minimized for the future estate tax payment on his death. Federal estate tax begins at an effective rate of 41% (on assets greater than the estate tax exemption of \$1 million) and moves quickly to 49% (on a taxable estate greater than \$2.5 million). Conversely, as you might imagine, the IRS is vigilant in looking for businesses that may have been undervalued in an effort to minimize taxes. This is particularly true for businesses whose fair market value is disputable.

Active and inactive heirs also may have different views of the business's proper value, especially if they don't hold interests in the business or if their inheritance is to be "equalized" from other assets (that is, compensated for their share of the business through assets other than the business itself). So make sure your valuator clearly understands the valuation's purpose.

**Transition.** Maite will turn 64 next year. Therefore, retirement is another option she must consider. If she chooses to keep the company, she must decide whether everyone now involved in the business should stay involved. That means assessing personnel's aptitude, ability and temperament. Then she must determine if only those children who are active in the business retain current, or have future, ownership of it. Finally, she must decide what inactive heirs should receive.

Without considering these issues, Maite would be less inclined to make an ownership transition during her lifetime. And that might not be in her (or her family's) best interests.

**Decision-making authority.** Presume at this point that Maite has decided to leave the business to her heirs. She must then determine who will take the helm when she leaves. If she's not done so already, she should empower those running daily operations to make important decisions. She should consider whether the decision-makers should report to a formal or informal



board of directors, or an institutional executor or trustee. With her M&A team of experts, Maite should examine whether her company can meet its capital and borrowing needs and how it can maximize its intellectual capital. If a solid management team already exists, it should have an incentive to stay on when the next generation of Maite's family assumes ownership and control.

**Full benefits.** Many business owners don't take into account the value and extent to which they are receiving benefits from the company in addition to salary. In our example, Maite must recognize medical benefits, perquisites, pensions and employment opportunities for herself, family members and others before deciding to retain or divest the business.

**Estate plan.** Contrary to popular belief, having the correct legal documents doesn't constitute a business continuity plan, nor should that plan remain static. Changing tax law and values require a periodic estate plan review, as do changing children's (and grandchildren's) ages, maturity and marital status. Health concerns also affect planning. If Maite wants to keep the business in the family, an estate plan is a key component.

## Letting It Go

Let's say Maite decides to sell the business to outsiders. Here's a look at the salient issues from the seller's side.

**Value.** A buyer bases a business's value on strategic benefit and fit with other businesses, earnings and cash flow, and the management team. For the seller (Maite in our example), the gross value most often determines whether to sell. Note that consideration paid can take several forms and should be carefully structured and negotiated.

**Getting at net value.** The extent, timing and payment of taxes (be they capital gains tax, income tax or estate tax) on the proceeds can and should be planned. Total purchase price should not be as important as the net value to the seller and his or her family. The buyer can be convinced to deliver more to the seller if it is more tax efficient for him or her.

### *Pertinent Considerations*

There's no one-size-fits-all answer to a businessperson's keep-or-sell conundrum. Fortunately, there are several constants. The decision to retain or sell a company includes considerations such as:

- ↳ The owner's desire to work or retire,
- ↳ Family dynamics,
- ↳ Financial security for working family members and shareholders,
- ↳ The current business environment as it relates to the business's market value,
- ↳ What will and should happen to loyal executive and employee groups,
- ↳ The extent of the owner's assets, and
- ↳ The tax impact.

These are a just a few of the many items to review before making a decision. Call us for more detailed information.

**Presale planning.** A great deal of planning should take place before any sale transaction. The more time that elapses between the implementation of a strategy and the sale transaction, the better the potential to preserve wealth and structure a deal that is beneficial to all parties.



**Transaction strategy.** Before a business goes on the market, have your expert examine its financial status and state it in the best possible light. In other words, balance sheets and income statements may need to be re-evaluated. Fortunately, Maite's M&A experts helped her identify an appropriate buyer (from a field of strategic, financial, institutional and management candidates) and communicated with that company's representatives throughout the process.

**Implementation and positioning.** Before negotiations began, Maite and her M&A team defined her role and others. By doing so, the sale process moved smoothly and she was on track to the best possible results. Experienced advisors helped her determine the most effective offer process.

**Post-sale planning.** Coordinating a change in the assets' makeup (for example, from stock in a closely held business to liquid assets) requires an income and security analysis and a review of any existing estate plan.

### Smooth Sailing

Chances are, you wouldn't drive to an unfamiliar destination without a map. Neither should an owner even contemplate selling a business without a plan. That plan will reveal the best course of action and chart how to get you there. Please call us to help you navigate your way to the successful sale of your business or with any other M&A issues you may have. [➔](#)

## Taxing Considerations For Business Sellers

When selling your business, tax considerations play an important role in maximizing the cash return to you and the rest of the shareholders. Because Uncle Sam will penalize you if he doesn't receive a share of the proceeds, it's in your best interests to ensure he gets his due — but not one penny more.

To minimize the tax bite, sellers must understand the legal implications of the terms and conditions at the start of the sale process. When you consider divesting your business, consult with your advisors to get appropriate advice. In the interim, let's discuss some basics so you better understand how tax laws can affect you when you sell your business.

### What's Your Type?

When you established or bought your firm, you either chose a business type or acquired an already formed business. Common business structures include C corporations, S corporations, limited liability companies (LLCs), general and limited partnerships, and sole proprietorships.



Note that S corporations, LLCs and partnerships generally are more tax friendly to sellers than C corporations.

Sellers of C corporations prefer to sell stock rather than assets for two primary reasons: All liabilities go with it, and, more important, only the stockholders recognize — and thus pay tax — on gains from the sale. In other words, there's no gain at the corporate level.

Buyers, on the other hand, prefer to pay for depreciable assets and assume only the liabilities that they want. When C corporation assets are sold at a profit (that is, marked up from book value), Uncle Sam takes two bites from the apple — one at the corporate level and one at the shareholder level after the company pays out what's left of the gain to its shareholders. Fortunately, in many cases the second bite will probably be smaller because of the new 15% tax rate on dividends under the Jobs and Growth Tax Relief Reconciliation Act of 2003.

Conversely, when an S corporation, LLC or partnership is sold, the gain or loss from selling the assets is passed directly through — with no tax at the corporate or company level — to selling stockholders, LLC members or partners. The buyer and seller must agree to the assets' value because the IRS requires the value of each asset class to appear in the sales agreement (or in one of the exhibits).



## *When establishing or buying a business, there are significant tax benefits from using the S corporation, LLC or partnership form of business.*

So, when establishing or buying a business, remember that there are significant tax benefits from using the S corporation, LLC or partnership form of business. Also, negotiate the transaction's structure; it may significantly affect what you as the seller can keep after taxes are paid.

If you're buying a C corporation, you can establish an S corporation or LLC to buy it. Then you can merge the C corporation into the buying organization. When it comes time to sell, you'll be able to reap the tax benefits we've discussed. Note that if you've converted a C corporation to an S corporation, 10 years must pass before a seller can receive the conversion's full tax benefits. So make sure (whether you're buying or selling) to consult with your tax advisor along the way or a nasty surprise may await you.

Often C corporation sellers will try to get a higher price from the buyer to offset a part of the larger tax bite. When that occurs, the buyer will want to make part of the consideration a consulting agreement, employment agreement or earnout. Why? These payment types are tax deductible to the buyer when paid to the seller, whereas funds spent on stock, inventory, fixed assets, goodwill and the like are not.

But, while these agreements are tax friendly to the buyer, they are tax *unfriendly* to the seller because any money received from these types of agreements is taxed at the "ordinary" income tax rate rather than the lower long-term capital gain tax rate.

Another consideration regarding taxes has to do with the timing of payments received. If you are selling your privately held company (either stock or assets) through an installment sale, you may report the gain on the installment method to time tax payments to coincide with cash received because of the sale.

### **Why Go It Alone?**

Tax laws and IRS rules and regulations are extremely complex. A savvy seller will seek sound tax advice throughout the divestiture process to minimize taxes and maximize take-home cash. Please call us to help ensure that Uncle Sam gets only what's coming to him. ➡

# Selling Your Business?

## Learn To Think Like a Buyer

**Y**ou've built a great business with love and care. The business has grown larger than you'd ever imagined, and it generates a nice profit that has allowed you and your family to live a comfortable life. Now you've decided it's time to sell. You assume there's a buyer out there who will pay you a fair price and then nurture the company with the same attention you have. What's more, selling the business is a major part of your retirement plan.

can make its company more attractive — and perhaps even increase its selling price.

The biggest factor directly affecting a deal's attractiveness is the asset base. Simply put, the more the buyer can borrow against to do the deal (or for post-transaction capital), the less cash you need upfront. As collateral, banks usually accept land, buildings, equipment, inventory and accounts receivable.



Needless to say, buyers look at businesses differently than sellers. So to achieve the outcome you want, it's important to think like buyers and understand how they evaluate a business. By entering the mind of prospective buyers, you can see what you can do to increase your company's appeal.

### What Buyers Look For

There are many types of buyers: strategic and financial, individuals, companies, and private equity funds. Despite differences, all buyers consider how much they'll invest to acquire a business, the amount of risk they'll bear and the potential return on their investment. To evaluate an opportunity, buyers focus on three major areas:

**1. Cost and terms.** What will it take to acquire the business? (How much cash and how much debt?) What are the deal's terms and conditions?

Because we're constrained by space, we'll focus on one standout issue: the amount of cash required to make the deal. By decreasing the cash requirement and increasing the acceptable debt portion, a seller

Many entrepreneurs have purchased the land their business resides on and leased it to the company. An often unanticipated side effect is that this structure reduces the company's asset base, thereby decreasing the amount of debt leverage the seller can obtain.

Another way sellers can reduce the buyer's initial cash requirement is by accepting part of the purchase price over time. Commonly known as "seller paper," this can do a great deal to lubricate a sale.

**2. Continuity.** Will the business continue to operate similarly after the sale? In fact, much of the risk of buying a company relates to continuity. Let's look at a few examples of potential continuity problems:

- ❧ The current owner has personal relationships with customers, distributors or vendors that the new owners may have to struggle to maintain.
- ❧ The current owner has special expertise that is undocumented and difficult to learn.
- ❧ Key personnel aren't committed to staying.
- ❧ A major threat of offshore competition looms.



Sellers armed with solid responses to these types of continuity concerns will more frequently get their desired price. Even if you don't want to sell your business for a few years, take steps now to ensure it can run smoothly without your personal involvement. That independence can be worth millions to you when you sell.

- 3. Growth.** Don't hesitate to point out unexploited opportunities. For instance, you may have focused your sales efforts in one geographic region, but there may be many opportunities to take the product national or international. A buyer who believes he or she can substantially increase revenues will

pay more for the business than one who believes the current owners have maximized opportunities.

## What Sellers Should Do

It may seem counterintuitive, but the things you may be most proud of can work against getting the best price for your company. Not many entrepreneurs like to boast, "My company would run just fine without me," or "There's lots of sales opportunities I failed to exploit." Yet these may be the very factors buyers seek, along with lower cash requirements. Please call us for help in understanding how to best present your company for sale. [→](#)

## 6 Common Seller Mistakes

Entrepreneurs can do several things that will positively or negatively affect the sale of a business. In this issue, we've focused on many of the positives. Now let's look at six common — and easily avoidable — mistakes.

- 1. Showing off how much everything depends on you.** There's a natural tendency to be proud of how well you know the business and how much it depends on you to run smoothly. But what buyers want is a business that will run smoothly *after* you've moved on. Emphasize the strength of your management team and de-emphasize your own importance.
- 2. Owning the real estate outside the company.** Many business owners remove assets from the company as a way to create financial security. The problem with this approach? It discourages buyers because there are too few assets to borrow against. Therefore, you may get more buyer interest if you include the property.
- 3. Poor financial reporting.** Poor accounting discourages more buyers than any other failing. At least two years before you try to sell the business, have an outside accounting firm start preparing audited financials.
- 4. Setting a high asking price.** Many sellers indicate an asking price as part of an offering. Ironically, the best way to actually get the price you want is *not* to ask for it. Instead, let buyers get interested and then watch them bid the price up.
- 5. Excessive personal business within the company.** Most business owners include some personal expenses inside the company because it lowers taxable profits. Up to a point, buyers understand and accept this practice. Just make sure that it's easy to explain and doesn't appear convoluted. Some businesses also employ several family members. This definitely makes selling the company more difficult because buyers may not understand who is staying on, what their real contribution is and whether they'll still be motivated after their relatives leave ownership.
- 6. Not seeking professional help.** Selling a business without seasoned professional assistance is always a mistake. Key members of your M&A team will include accountants, investment bankers and attorneys.



## **GILBERT A. HERRERA**

Founded the firm in 1992 and was previously the director of Coopers & Lybrand's Southwest region corporate finance group, responsible for building a new practice consisting of private placements, mergers and acquisitions and valuations. As the senior investment banker for Underwood, Neuhaus & Co.'s corporate finance department, he revitalized the firm's private placement and merger and acquisition effort.

Mr. Herrera graduated from the University of Texas at Austin, where he is a member of the Dean's Council for the McCombs School of Business, Longhorn Foundation for Intercollegiate Athletics, Advisory Council of the Ex-Students' Association, the Littlefield Society and the Executive Committee of the Chancellor's Council of the University of Texas System.

He currently serves as the President-elect of the Turnaround Management Association, Houston chapter the leading education and advocacy group dedicated to the corporate renewal industry. Additionally, Mr. Herrera was recently appointed to The Commission of 125, *Planning for the Future of the University of Texas at Austin*.

In 2001, Mr. Herrera was appointed by Governor Rick Perry to serve as Chair of the General Services Commission and its transition to the Texas Building and Procurement Commission. Previously he was President of the Briargrove Property Owners, Inc. and Chair of the Facilities Committee for Post Oak Little League, Inc. By appointment of the Supreme Court of Texas, Mr. Herrera served as a member of the Commission for Lawyer Discipline from 1993 to 1999 and Chaired their Budget Committee.



Merger and Acquisition Advisory Services



Debt and Equity Placements



Valuations, Fairness Opinions  
and  
Expert Testimony



Restructurings, Turnarounds and Reorganizations

*Celebrating our 10th Anniversary Specializing in Value-Added Distributors and Contractors  
Serving the Energy, Telecommunication, Food Products and Health Care Markets.*

*[www.herrera-co.com](http://www.herrera-co.com)*

1502 Augusta, Suite 260 ♦ Houston, Texas 77057  
(713) 978-6590 ♦ Fax (713) 978-6599