

WHAT YOU NEED TO KNOW

Before Selling Your Business



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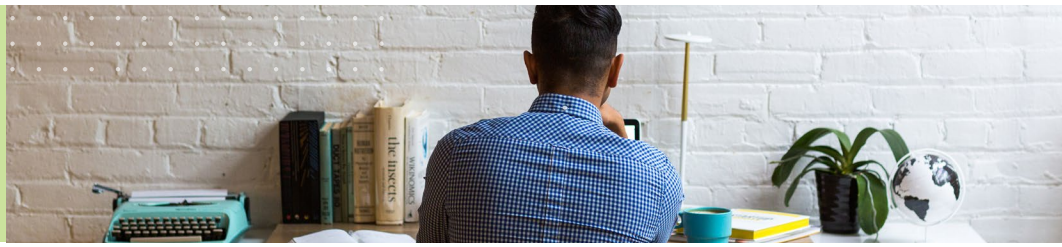
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Introduction

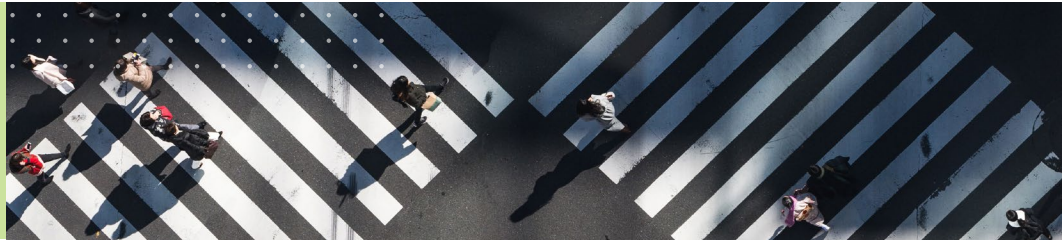
Many business owners went through a financial crisis in 2008 and have been weathering the pandemic and related economic fallout since early 2020. In addition, technology is fundamentally changing the way many businesses operate.

With all this turmoil, it's not surprising that many business owners are interested in exiting their businesses earlier than anticipated. In fact, the number of business owners who plan to retire sooner than originally planned has doubled in less than a year, according to [research](#)¹.

Selling the business often seems like the best exit strategy for an owner, but it's not a simple process. Securing a buyer and completing a sale is, for most owners, a once-in-a-lifetime experience. In this guide, we provide an overview of the entire process, from preparing a company to be sold to completing the transaction, along with important information business owners need to know about each step.

1. <https://www3.wilmingtontrust.com/content/dam/wtb-web/wtb-migration/pdfs/Wilmington-Trust-Business-Owner-Outlook-Rush-to-Retire.pdf>

CHAPTER 1



Preparing Your Company for a Sale

Selling the business that you've poured your time, energy and life into building is no small task. For most business owners, the business is like a child they have loved and nurtured into adulthood—and selling it can be both emotionally difficult and financially significant.

For most owners, the business powers every other aspect of their lives. It provides a regular income, retirement savings, social interaction and structure to their days and weeks. When you make the decision to leave your business, you need to make sure the business is in the best shape possible to attract the right buyer and the right price.

By adequately preparing your company for a sale, you'll be more likely to attract a buyer with whom you feel comfortable leaving your "baby" and a price that will ensure a financially comfortable retirement for you. Follow these steps to get your business ready for a successful sale.

When you make the decision to leave your business, you need to make sure the business is in the best shape possible to attract the right buyer and the right price.

1. Organize Financials and Reduce Discretionary Expenses

When you're running your own business, it's common to make pragmatic decisions at the cost of "perfect" accounting. For example, maybe your business operates in a family-owned building and pays rent that is below (or above) market rate. Or perhaps you run some personal expenses through the business account and reimburse the business from your personal account.

If you want to sell your business, it's time to clean up your financial statements. That means stop overpaying or underpaying rent and remove any personal expenses. Also, work to accelerate the value of the business in anticipation of the sale. For example, you might increase the value of your business by signing new sales contracts, adding new equipment, or expanding your product or service lines. Potential buyers will want to review your financials, and it's crucial that you have clean financials and a business that can accurately reflect its value on paper. Ideally, this process begins three years prior to marketing your business for sale, but it's never too late to start.



2. Consider Business Structure

Before selling your business, you also have to think about the business structure you have in place—and how long it's been in place. That's because the tax implications on a sale vary depending on whether the business is a C corporation, S corporation or partnership.

For example, a C corporation that sells assets for a gain would be taxed twice, once at the corporate level and once again when the after-tax proceeds are distributed to shareholders and taxed as dividends. Some business owners convert their companies to S corporations before selling to reduce taxes, but this only works if you plan to wait at least five years before selling the business.

If a business is sold within five years of converting to an S corporation, the tax benefits of making the election will be voided. If you're planning to sell in less than five years, avoid converting your business to an S corporation—or if you're planning to convert your business to an S corporation, plan to wait at least five years before selling.

3. Select the Right Advisors for Your Transaction

To help navigate the tax implications of various scenarios, as well as other ramifications of selling your business, you need help from the right advisors. Keep in mind that the right advisors may not be the attorney, banker, accountant or other advisors you've always used.

Why shouldn't you rely on the same advisors who have helped you launch and grow your business? Because the skills that were needed to grow your business are not the same skills and expertise you need to sell your business successfully. Because not all advisors are created equal when it comes to a sale, take time to interview your current advisors and others who may be a good fit. Find out their comfort level with selling businesses and how many deals they've done.

Also, prepare to pay advisor fees. Remember that you get what you pay for; if you want to achieve a successful sale, you're likely to experience a smoother process when you have the right advisors helping you.

The type of advisors you need may depend on your ambitions for the sale of your business. For example, if you're looking for an outside buyer, a business broker, or investment banker, can often provide a valuable network of connections. However, if you're planning to do an internal sale, you may not need a broker and it may not be worth spending the money.

4. Value Your Business Objectively

Attaching the right price tag to your business can help you attract the right buyer, and sooner. But valuing a business—especially a business to which you are emotionally attached—can be tricky.

Many business owners have a flawed perception of the worth of their business, Davie Kaplan advisors say. To arrive at the right figure, try to throw out your ego and your personal expectations. The true value is what someone is willing to pay for it, so you'll need to conduct some research and determine a realistic range.

To truly maximize the value of your business and accomplish a successful sale, you need to start early. Most experts recommend about two years to get things in order to prepare your company for a rewarding sale.

CHAPTER 2



Identify Your Market

The buyer of your business will determine the company's future and what it will look like. For example, the buyer will decide whether to keep your current employees or let them go, and whether to raise prices or move out of your current customers' neighborhoods.

Before identifying a buyer, it's important to think about what's important to you: Do you simply want to get a fair price for your business? Or are you concerned about how the business will be managed in the future? Do you want to have some say over future decisions, or will you be ok with selling and simply moving on? Your answers to these questions will determine the type of buyer you should seek.

But your preference isn't the only thing to consider. You must also think about the type of buyer that may be interested in your business. And if your first-choice buyer type doesn't work out, determine whether you are still committed to selling. Here's a look at the various types of buyers to consider and how to decide which one to target.

It is important to think about the type of buyer that may be interested in your business.

Gauge Interest Among Employees and Family Members

Business owners often hope that they can keep the business within their own families upon retirement. However, business advisors at Davie Kaplan observe that more than half the time, the owner's children and grandchildren are not interested in the business.

If your plan is to transfer ownership of your business to a family member, don't assume that he or she will be on board. Take time to have a frank conversation about the family member's level of interest and expectations.

In some cases, if a family member is not interested or available to take over the business, an internal employee may be a good choice. Consider whether you have a current employee who has the financial acumen and entrepreneurial mindset to take over and run your business. If so, talk to him or her about the possibility and their level of interest.



Consider Local Competitors Versus Private Equity Firms

If you don't have a family member, employee, or another person who is already familiar with your business and interested in buying it, you'll have to broaden your search. Usually, the choice is between a local competitor or small business owner or a private equity or venture capital (VC) group.

In some industries, geographic proximity matters a great deal. For example, say you've built a well-known appliance store and service center over the past 50 years. In the absence of a family member or employee willing to take over the business, the next best option might be the owner of another appliance store from a nearby town. The local competitor may already have name recognition among many of your customers, as well as the ability to retain many of your current employees and customers without missing a beat.

In contrast, a private equity or VC firm may be able to offer you more money than a local competitor. However, the private equity or VC firm may not be able to guarantee ongoing employment for your current employees or management. If that's important to you, you could consider including requirements to that effect in the purchase agreement—but there's no guarantee that the buyer will agree to those terms.

Which Option Will Provide You With the Best Outcome?

To determine the right buyer for your business, think carefully about the outcome that matters most to you. Are you most interested in:

- » **Getting the most money for your business**
- » **Having the ability or requirement to continue working in the business**
- » **Maintaining your current employees' jobs**

When you've determined your top priorities for the sale, examine each of the potential buyers—a family member, an internal employee, a local competitor or a private equity firm—and determine your personal financial outcome, as well as the outcomes for your other priorities, in each scenario. If your child or other family member is interested in the business and you want to pass it to him or her, but you also need to make money on the transition, a progressive step acquisition may be an option. (Progressive step acquisitions are discussed in [Chapter 4](#)).

After examining each scenario in relation to your priorities, you should have a good idea of what the future will look like for you and your business with each type of potential buyer.

CHAPTER 3

Evaluate Alternative Sale Structures

Generally, you have two ways to sell a business. First, you can sell company stock known as a “stock sale.” Stock is always owned by shareholders, rather than by the company itself, so in a stock sale, the individual shareholders (such as you, the owner and any partners) sell the stock. Second, you can sell the company’s assets; this is known as an “asset sale.” In an asset sale, the buyer purchases assets from the company itself rather than from individual shareholders.

Each of these sale structures offers different benefits and liabilities for both buyer and seller. If you’re open to both types of sale structures, you may attract more or varied buyers. But before agreeing to a certain type of sale, it’s important to understand the tax and liability consequences of each one.



Asset Sale

Typically, for tax and liability reasons, most business buyers want to purchase the assets of the business, rather than undergoing a stock sale. In an asset sale, the buyer can limit his or her liability for business obligations to things that arise after the sale. He or she can make sure that former stockholders would remain responsible for the company's pre-sale liabilities.

In addition, with an asset sale, a buyer's tax basis will be the amount he or she chooses to pay for those assets. The buyer has more control over his tax basis with an asset sale, because he agrees to pay a certain amount for the assets. On the other hand, with a stock sale, the buyer isn't paying directly for the assets, so his cost basis would be based on what the seller previously paid for the assets.

If you decide to sell your business through an asset sale, you and your buyer will have to negotiate prices for various assets including capital assets, depreciable assets, and intangible assets, such as goodwill, licenses, patents, trademarks, supplier loyalties, and business methods.

Stock Sale

Typically, sellers prefer a stock sale over an asset sale. Selling stock is usually less complicated than selling assets. Stock sales may be necessary if certain contracts or intellectual property can not be easily transferred.

For sellers, a stock sale typically means they no longer have sole responsibility for things that happened in the business prior to the sale, such as tax obligations and product warranties. To compensate for the extra liability, however, a buyer may ask the seller to agree to a warranty that the business's liabilities will not exceed a certain amount, or the seller will reimburse the buyer for expenses over that amount. A stock sale buyer may also request to pay for the business in installments over time or to include a consulting arrangement in the deal, so that the seller must stay on board to provide advice for a certain length of time.

A stock sale typically means sellers no longer have sole responsibility for things that happened in the business prior to the sale.

When it comes to taxes, a stock sale offers advantages for the seller. The sale of stock is subject to capital gains taxes, which are lower than the ordinary income tax rate at which the sale of assets would be taxed. Because the stock is sold by the shareholders, the business itself recognizes no gain or loss when its stock is sold. That results in a seller paying tax only once, on the sale of his or her stock. In contrast, an asset sale may create double taxation, once on the corporation and once on the shareholders when they receive dividends.

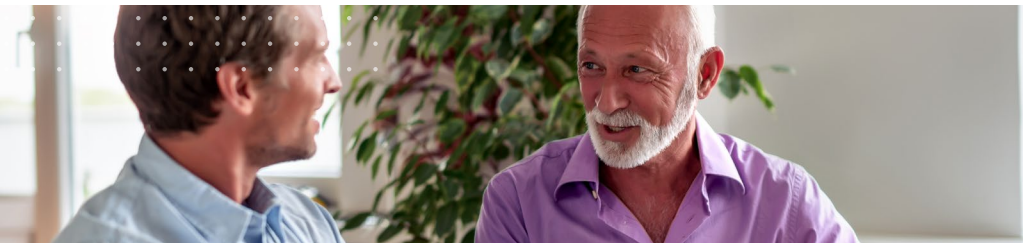
Get Help

Because tax and liability implications of both asset sales and stock sales can be highly complex, it's a good idea to work with a CPA who understands all the options available for the specific sale structure you choose. An advisor who has deep experience in structuring the sale of businesses will be able to help you negotiate and provide options that may satisfy both the buyer and the seller.

For example, if you want to sell your business as a stock sale, but your buyer wants to purchase it as an asset sale, an experienced advisor can help develop a strategy that may work for both of you. A CPA who has experience with structuring business deals can file a 338(h)(10) election, which allows you to sell the Company stock, but allows buyers to treat the acquisition as an asset purchase for tax purposes.

Taking time to understand the ins and outs of various business sale structures can help you be better prepared to negotiate a sale that will meet your needs and goals.

CHAPTER 4



Funding the Sale in a Generational or Internal Transfer

Many business owners dream of leaving their beloved businesses to their children or grandchildren and keeping their life's work in the family. However, those same owners often count on the sale of their businesses to fund their retirement years—and because their children or grandchildren likely don't have the assets (or credit) to actually pay them an amount equal to the value of the business, it may seem as if their dream simply won't work.

If you're in this dilemma, don't worry. It's possible to transfer your business to a family member or internal employee without requiring him or her to outlay cash, while you still profit from the transition. The best way to do this is with a progressive step acquisition. This type of sale allows a new owner to gradually increase his or her ownership of the business over time, and allows the seller to gradually monetize the sale of the business over a period of several years.

A progressive step acquisition allows a new owner to gradually increase his or her ownership of the business over time.

How Does a Progressive Step Acquisition Work?

With a progressive step acquisition, a key person (such as the owner's child or grandchild or a current managerial employee) takes the reins and a small percentage of ownership. He or she grows the business, making more money over time. The seller still owns a portion of the business and is able to participate in and benefit financially from that growth, but he or she no longer owns all the risk.

Over a set number of years, the seller's share of the business gradually decreases and the new owner's share gradually increases. This can be accomplished with various vehicles including gifts, bonuses or capital contributions funded by their minority share of Corporate profits.

When the new owner reaches about 40 percent ownership, most sellers undertake a full distribution for the balance of their ownership. At this point, the seller receives a lump sum payment for the rest of the business. This is generally funded from bank financing. The whole process usually takes 7 to 10 years.

The seller takes a portion of the business's earnings throughout the transition period, but he or she is no longer responsible for managing all the risk or the day-to-day operations of the business. When the transition is completed, the seller takes his or her full distribution. Because the business grows and increases profits during the transition period, the seller takes significantly more out of the business than if he or she had sold it outright.

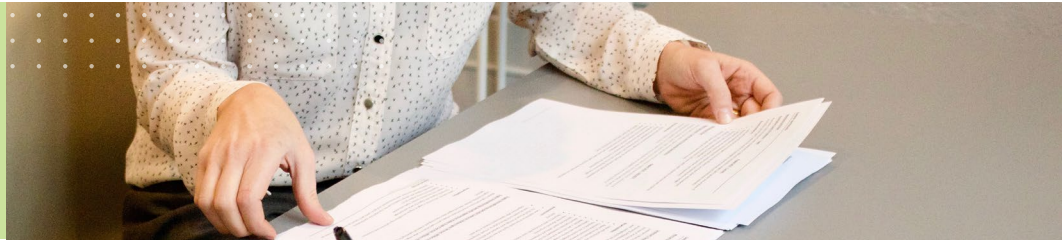


Answering Objections

Some owners reject a progressive step acquisition because they think it seems like they're "getting paid with their own money." However, if you're selling the business, it's not your money anymore. As soon as the new owner is involved, you are no longer responsible for all the risk. And if you're able to let go and allow the new owner to manage (or share in) business operations, you're also no longer solely responsible for the day-to-day work. If the new owner grows the business as planned, you benefit from his or her contributions without having to run the business and manage the risk on your own.

Most business owners who choose a progressive step acquisition aren't doing it only for the money. If your goal is to keep your business in the family or with another person you care about, a step acquisition may allow you to do that while still benefiting financially from the sale.

CHAPTER 5



Tax Strategies for Selling a Business

Before selling a business, it's crucial to understand how the sale will affect your tax bill. By taking advantage of a number of strategies to minimize your tax liability, you can keep more of the profits from the sale of your business to fund your retirement or your next business venture. Understand the basics of these tax strategies before you commit to selling your business.

Installment Sale

Basically, an installment sale, which uses a seller-financed note, allows a buyer to finance the purchase of your business over multiple years, and allows a seller to pay taxes on the sale over multiple years. While you transfer full ownership at the time of the sale, the buyer makes payments to the seller over time, including interest.

As the seller, you receive capital gains income as well as interest income until the payment period is complete. Your long-term capital gains will be taxed at the tax rate in effect in the year the payments are received, and it is possible to structure the installments to keep your taxable income below a certain income tax bracket.

Note that an election for installment sale treatment is not permitted for gains on ordinary income property, such as sale of inventory. Ordinary gains must be recognized in the year of sale, regardless of when you receive payment.

Post-Sale Employment Contracts

Sometimes, a business buyer will want the seller to stay on board in some capacity after the sale is completed. If you plan to continue providing services to the business after the sale, it may benefit one or both parties for you to sign a post-employment contract or non-compete agreement.

With a large, one-time business purchase (e.g., \$2 million), the buyer does not get to deduct the full purchase price right away. But with a post-sale employment contract, they could break the purchase price into smaller “wage” payments over a few years. That way, the seller gets the money as income, and the buyer gets a faster deduction.

As the seller, you may want to get the smaller payments in the form of wages over a longer-term period to avoid a big tax bill in one year. With a post-sale employment contract, you’ll be guaranteed to earn wages from the business for a certain number of years, with a portion of your taxes paid by the employer.

Allocation of purchase price to a non-compete agreement could recharacterize a portion of the gain from ordinary to capital which may provide lower, preferential tax rates.

Personal Goodwill vs. Corporate Goodwill

When the owner has personal skills (such as technical skills) that are integral to the business, he or she can segment the purchase price of the business into parts. For instance, you may be able to charge a certain amount for the personal goodwill and another amount for the corporate goodwill.

By breaking up the payments in this way, you may be able to lower your tax bill on the sale of your business. However, there are certain hoops to jump through (e.g. valuation of personal goodwill) to obtain these tax savings.

Deal-Specific Tax Strategies

Various types of business deals offer opportunities for different tax strategies that are specific to the sale structure. For example, if your business plans to pay out large severance packages to executives, you may face potential tax penalties. Make sure your advisor understands the strategies you need to undertake in order to avoid those penalties.

Again, it’s very important to work with tax advisors and business advisors who understand the ramifications of various sale structures and are able to advise you knowledgeably about how to make the right choices and use the right strategies to minimize your tax liability.

**CONCLUSION**

Time to Sell?

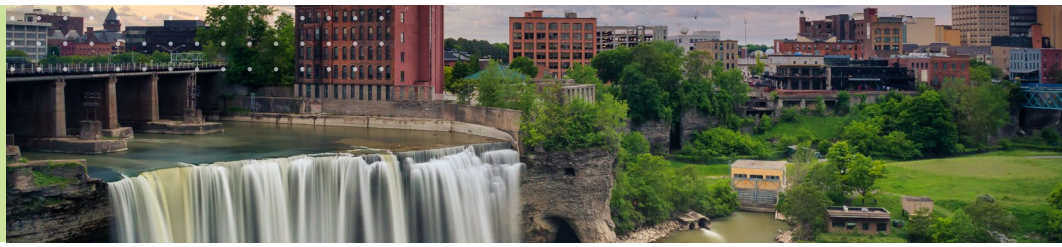
More owners are contemplating selling their businesses, and the market for selling is strong.

The number of business sales closed during the third quarter of 2021 increased 11 percent over the second quarter, and 11 percent over the third quarter of 2020, according to [BizBuySell's Insight Report²](https://www.bizbuysell.com/insight-report/), which tracks and analyzes U.S. business-for-sale transactions.

Not only are more businesses selling, but they are selling for more money. Buyers are paying record prices for businesses that have continued to perform well during the pandemic, and the median sale price during the third quarter of 2021 was 17 percent higher than the previous year and 40 percent higher than 2019's pre-pandemic third quarter prices, the BizBuySell report shows. During 2021, seller confidence rose to 57, up from 45 in 2020 and the highest level since 2018.

As we've shown in this guide, there are a variety of best practices to follow and knowledge to be gained in order to position your business for the most effective sale. Finding the right buyer and closing the sale on your business can be a relief, as well as an empowering first step toward creating the retirement you've dreamed about. Understanding the steps included in this guide and following them deliberately can help ensure a successful sale of your business and prepare you for a secure future.

2. <https://www.bizbuysell.com/insight-report/>



About Davie Kaplan

As one of the region's leading CPA and advisory firms, Davie Kaplan has been guiding Rochester businesses and families for over three generations.

Whether you are looking for a CPA firm with proven expertise in tax, compliance, and financial management for our region's key industries, including construction, manufacturing, real estate development, and multi-family property management—or need holistic analysis and advice to support your plans for expansion or business transition, our team brings focused experience and on-call resources to the table.



In an economy rife with uncertainty, Davie Kaplan brings you practical solutions and strategies to anchor your growth and long-term success.

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