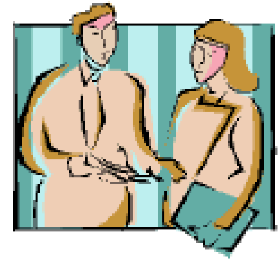
# *Using Deferred Compensation to Sell Your Business*



**by Josh Patrick, CFP®**

***At some point in your business life you will leave your business. For most people the goal is to leave with as much money as possible. Unfortunately, most of us concentrate on pre-tax dollars and not what you are left with after paying taxes. This article will concentrate on how to maximize after tax dollars in a sale to a third party.***

## Introduction

At some point in your business life you will leave your business. For most people the goal is to leave with as much money as possible. Unfortunately, most of us concentrate on pre-tax dollars and not what you are left with after paying taxes. This article will concentrate on how to maximize after tax dollars in a sale to a third party.

Although this article concentrates on selling your business to a third party, the same strategies can put in play when selling to your management team or your family. However, as with all strategies, remember you will have to fine tune your plans for your own particular situation.

When a buyer wants to purchase your business, they will want to do so at the lowest possible cost. In addition, they usually don't want to have your potential corporate problems and thusly want to purchase your business through an asset sale instead of buying your stock. As a result most businesses that are sold have a component of assets and a component of a covenant not to compete as part of the sales process.

## The standard purchase

*John Aardvark wanted to sell his business. Had an offer from Bigco for $5,000,000. Since John's business was an S Corporation the buyer wanted to purchase the assets of the company. In addition, Bigco was going to hold out 25% of the sale and pay it off over the next five years as a covenant not to compete. John's basis in his stock was $500,000, so he was looking at quite a high tax burden which was going to be about $1,100,000 leaving him with $3,900,000 five years from now when the sale was complete.*

For John, the outcome of having only 22% of the sale go to taxes is a pretty good result. However, it still has a high tax cost. Whereas John thought he could spend about 4% of the asset base per year or $160,000, he now will have to either spend a higher percent of the asset base or spend less money each year from his sale. Either one of these outcomes could be unacceptable, forcing John to take his business off the market.

The reason Bigco wanted to take twenty-five percent of the purchase and have it be a covenant not to compete was so they could immediately write off the money paid for the sale. For the other $4,000,000 of the purchase price, Bigco was going to earn the money for the purchase, pay taxes on those earnings and then pay John for the company. In effect Bigco was going to have to earn $7,700,000 to pay John $4,000,000 for his assets and $1,000,000 for a covenant not to compete. This would make the total purchase price on a pre-tax basis for Bigco $8,700,000.

Understand that when you sell your business, the buyer is purchasing most of the business with after tax dollars. So with a 40% tax rate, the buyer has to earn $1.67 for every dollar they give you for your business.

Under normal circumstances with a very standard purchase plan the total Federal tax cost is approximately $3,600,000 on a $5,000,000 transaction. If we add state taxes to this number, the state tax cost would most likely average $700,000 bringing the entire tax cost to $4,800,000 or 96% of the entire purchase price.

In the standard sales situation, both the buyer and seller have a huge tax drag to worry about. In fact, between the two sides, there would be a tax cost of $4,800,000. Since this is an S Corporation, the tax bill is lower than with a C Corporation. If John had a C Corporation, the tax bite would have been higher, bringing the total tax bill for buyer and sell to more than 100% of the sale price. Also, if this was John's first time of looking at the sale of this business, he most likely would have taken it off the market because the after tax dollars from the transaction would not have been enough to continue his life-style.

### John's conundrum

*John truly wanted to sell his business. However, his combined State and Federal Tax cost was going to run him close to $1,100,000. He was very excited about getting $5,000,000 for his business, but netting $3,900,000 just was nearly as exciting for him. He tried to get Bigco to come up with more money, but their cost was going to be close to $8,700,000 before taxes and there just was no more money for them to pay for the business. In fact, after their advisors told them about the total cost of purchasing the business, Bigco was not nearly as enthusiastic about buying John's business as they first were when negotiations began.*

The case above is very usual in the ebb and flow of business acquisitions. The buyer and seller both become less excited about the transaction because their professionals have informed them of the bite that Uncle Sam will take out of the transaction. In addition, both parties to the transaction will often not spend any time talking with each other about the purchase and brainstorm ideas that could reduce the tax cost for both parties.

I find that when we help people transition their business to another party, the tax issues always rears its ugly head. So, we've learned that to make these deals work, we must look at the lowest tax cost which often will reduce the after tax price of the business as well as increase the amount of money the seller will receive on an after-tax basis. Again, it's important to concentrate on either your fully taxable cost as a buyer or your after tax receipt as a seller.

John told his advisors that he wanted to get $500,000 in cash out of the business and then he wanted $125,000 per year after that to live on. He would be happy to see the rest of the money go into an investment account that he could use later in his life as long as he could dip into it from time to time for special things he might want to purchase.

One of the first activities you should pursue when selling your business is to figure out how much money you need at what time when you leave your business. If you think about your business in this manner, you will often find ways of structuring your business sale that will allow you pay less tax upfront defer taxes for many years and give the buyer a much higher write off when they purchase the business from you. You will find that using multiple strategies and corporate structures can be very effective in helping you achieve this goal.

### The win/win solution

*John went to a tax specialist in business transition issues and presented the problem he had. Since no papers had been signed, the tax specialist suggested four strategies that could be used to help him get more money from the buyers and have his upfront tax cost reduced by over 90%. Unfortunately, for the short-term John had to tell the buyer that the transaction could not be completed for six months while all the planning was put in place. John also had his advisors work with Bigco's advisors to help them understand the strategies employed and how Bigco could and should enthusiastically increase the purchase offer by $1,000,000 to a total price of $6,000,000.*

I believe that you should plan for the sale of your business at least five if not ten years before it happens. Your goal when you sell your business is to help the buyer convert as much as possible of the purchase price to operating expenses so they can deduct the cost of your business in the first year.

By doing this, you can demand a higher price for your business because you are asking the buyer to give you one dollar for every dollar received instead of a tax burdened dollar that cost the buyer $1.61 or more. (Remember to give you one dollar for assets, the buyer must earn the dollar and the taxes that must be paid to use that dollar. In the case of Bigco, they would have to earn $1.61 for each dollar they gave John for his assets.)

John's advisor had John put together a deferred compensation program that would require the company to pay him $200,000 per year for twenty years after he reached normal retirement age. The deferred compensation document also had a put option that required the deferred compensation be paid in cash if the business was sold. This in effect, put a liability on the books for $4,000,000 which was used as a drag on the value of the business. With this one change in the corporate structure John made an offer to Bigco that the business sale should be structured as follows:

- $500,000 would be paid for the assets of the business. This would allow John to get his money back that he already paid taxes on.
- $4,00,000 would be paid 45 days after closing to a third party that would enter into an installment sale with John. The installment sale would provide John with no money for five years, but would provide him with $150,000 per year with an inflation factor of five percent for fifteen years and the balance left on the note would be paid to him twenty years after the business was sold.
- $1,500,000 would be paid over five years to his company as a management contract for John to provide advice to Bigco on business operations.

**John's cash flow from the sale would be:**

- John would receive $500,000 immediately which he would not have to pay taxes on.
- John would receive $300,000 per year in paid to his old company as a management fee. John would pay himself $150,000 in salary and he would also set up a one person defined benefit plan which would allow him to shelter $150,000 per year in a tax-deferred Government qualified retirement plan.
- Five years after the sale, John would begin to receive $150,000 per year from his third party installment sale. The $4,000,000 that would be invested in this account would get a market rate of return and have a 5%inflation factor put on the payout. At the end of the installment sale, any money left in the account would be paid to John in a lump sum.
- John's first year tax cost would be reduced from $1,100,000 to about $40,000.

**The results for the change in the way the sale was made for Bigco is:**

- Bigco's purchase cost would be reduced from $8,700,000 to $6,400,000 which includes the additional $1,000,000 that Bigco paid John for the business.
- Bigco would be able to write off $4,300,000 of the business purchase price in the first year.
- Bigco's tax cost for the transaction would be reduced from $3,700,000 to $400,000.
- Bigco would have a total cash savings of close to $2,300,000 after paying John an additional $1,000,000 for his business.
- Bigco would have had a tax reduction in the year of the business purchase of $1,7000,000 versus $350,000 under the original deal.

## Conclusion

By changing the way the deal was structured, we made major improvements for both sides. First, John reduced his taxes by over $1,000,000 on the deal. In addition, he increased the amount of money he received by over $1,000,000 giving him a $2,000,000 improvement on his side of the deal.

Bigco reduced their upfront cost of purchasing the business by $2,300,000 which included giving John an additional $1,000,000 over the original purchase price that was agreed upon. In addition, Bigco received a first year tax deduction of $4,400,000 which made about 75% of the deal tax deductible in the first year. This means that Bigco would reduce the cost in the first year by over $1,500,000 which is the direct reduction that Bigco would have in taxes as a result of the huge write off they would receive for paying John's deferred compensation plan.

By restructuring this transaction both John and Bigco came out big winners. Bigco ended paying significantly less for the business on an after tax basis. John ended up having much more money to spend with most of it growing on a tax deferred basis. All of this was accomplished by just thinking a little differently about the outcomes each wanted from the business transition.

A final note: Please make sure you bring competent professionals in on the discussion well before you start down the road of selling your business. The earlier you put the instruments in place discussed above, the stronger your case is with tax authorities who might want you to pay more than the amount you legally owe.

*The examples used in this article are based on real events however; industries, cities, names and genders have been changed. Copyright 2003 The Patrick Group, Inc.*

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