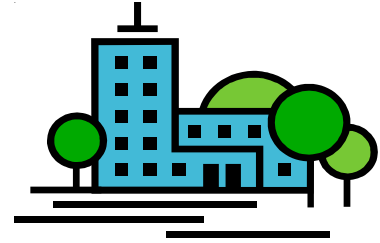


# *Purchasing a Business - A Tax Friendly Strategy.*

*by Josh Patrick, CFP®*

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## **Introduction**

Many operators of businesses have a chance to purchase a business which looks like it can add a tremendous amount of value to your present operations. You do the work and look at the options you have for purchasing the business and figure you can pay for the business easily but when it actually comes time to pay for the business, the cash flows never seem to work out the way you expected them to.

*John Aardvark has an opportunity to purchase one of his competitors operations. He is very interested in doing the transaction and wants to make sure that he can pay for the operation in 2.5 years or less through additional cash flow to his business. In the past, when he's purchased businesses he has had a difficult time paying for them. They all seem to cash flow well on paper, but when it comes time to pay for the operations, he always seems short on cash.*

The problem that John has is that he has been purchasing other operations on an asset sale basis. As a result, much of the purchase he has been making is amortized over fifteen years. This forces him to use after tax dollars to purchase his operations.

For example, if John were to pay \$1,000,000 for another operation, he would have to make about \$1,800,000 to pay the \$1,000,000 for the business. Since the principle portion of the business is paid for in after tax dollars, John first has to earn enough to pay the taxes and then give the money for repayment to the bank or the person he is purchasing the business from.

This means that John is often paying almost twice for the business. First, he is paying Uncle Sam the taxes on profits he makes and then he is paying either the bank back for the loan or paying money to the old owner of the business. Unfortunately for John, he had never factored the cost of taxes into his purchase plans and as a result, he never hit his profit goals for the purchase of the business he had acquired.

## **The acquisition process**

*John decided that he needed a process for evaluating, negotiating and purchasing his next business. The last business he bought not only didn't cash flow the way he thought, but the amount of business he thought the business actually did was significantly less than the ex owner promised. Unfortunately, John didn't have any agreements for less money to be paid for the business than originally agreed upon.*

When purchasing a business there are several steps you should do to help you first understand what specifically you're buying, second how much you can afford to pay for it and finally what to do if the facts of your acquisition are not what they were warranted and presented during the acquisition process. I suggest you consider following the action steps below when it comes time to think about making an acquisition.

1. Understand how the acquisition will fit into your business.
2. Realize the true cost in purchasing the business.
3. Understand how you will run the new business.
4. Understand the role of the staff in the business you are acquiring including the selling owner.
5. Have a thorough understanding of what you are purchasing.
6. Have documents in place that have penalties in place that will compensate you if promises the selling owner makes are not true.
7. Have cash available in a hold out to compensate you if the warranties the selling owner makes are not true.

When you want to purchase someone else's business, the first question you need to answer is how this new operation will make my present business better or stronger. If the business is in the same line that you presently are in, this is the easiest business to justify. If the business is in a related line you might want to expand in this area and the expertise of the new business could help you get up to speed more quickly.

In either case, it's important for you to do very detailed proforma's on the cash flow that will be provided by the operation you are thinking of purchasing. Most importantly, you must factor the cost of taxes in this calculation. If for example, your acquisition is going to provide you with an additional \$100,000 of cash flow per year, you must take the extra taxes you will pay and reduce the cash flow by that amount. So, if you are in the 40% tax bracket you will want to reduce your net cash available by \$40,000 which now gives you a projected \$60,000 in available cash.

I would also increase the operating costs you are projecting in your proforma by 10 to 20 percent. So, if your operating costs for the new business would be \$400,000, you would then want to have an additional \$40,000 to \$80,000 of actual costs for the first eighteen months of the new operation. In our experience, there are always extra costs that you did not anticipate when purchasing a new business.

In our example above, if we have a cash flow of \$100,000 we will then incur between \$40,000 and \$80,000 of extra costs. We would then be left \$20,000 to \$60,000 of extra cash before taxes. In a 40% tax bracket, that means we would actually end up with \$12,000 to \$36,000 in available cash. This is the cash we will have available to pay for the business that we've purchased.

*When John saw the actual numbers for what the acquisition would add to his business, he started to bear down on what the actual value of the business would be to his operation. On paper it looked liked the business made no sense, but he was convinced that in a relatively short time he could bring improvements to the operation to not only pay the departing owner but add real cash flow to his own business. He thought his team could bring operational efficiencies that would make the added sales worth purchasing.*

After you have analyzed the numbers for the business you are purchasing, you must also analyze the people that will be coming with the new business. You will often find that the old owners and managers of the business have habits that don't fit in well with how you do things. So, you need to have a plan to either have the team from the purchased business pick up your culture or more likely, make arrangements to replace these managers with people on your team.

You will want to make as few promises as possible about continued employment for owners and managers of the company you are purchasing. If you give either managers or selling owners employment contracts, you must factor the costs of these contracts into the purchase price cost. In our experience, we see very few owners of selling companies stay with acquiring companies for more than eighteen months. So, if your agreement calls for continued employment for five years, it's important to know that you might be paying an employment agreement that has no work attached to it.

However, making the employment agreement part of the purchase price is a very positive tax strategy for you as a buyer. This is because that employment agreement is a tax deduction for your company. So, if the employment agreement is for \$50,000 per year and you are in the 40% tax bracket, the actual cost of the agreement will be \$30,000. This happens because you will be reducing your tax liability by 40% of the amount you pay the departing owner if it is categorized as a business expense such as salary.

*John thought he had a pretty good general understanding of the business that he was purchasing. He was ready to make a contingent offer based on doing research on the specifics of the business. He also wanted to have the selling owner guarantee that statements he made about his business, the assets of the business, the Customers and contracts of the business were true.*

This is the stage you might want to make a contingent offer on the business you are looking at. It also is the time you do the very best you can to make sure that you are purchasing what you think you are purchasing. This process is called due diligence.

Typically, you have now made an offer based on the profit and loss statement, cash flow statement, balance sheet and information the selling owner has given you. The purpose of due diligence is to use various testing mechanisms to make sure that the information you've received is accurate and verifiable.

This is the time in the process you might look at Customer lists, route service schedules, operational specifics and production processes. If any of this research shows that the owner's warranties were not what he or she told you, it's imperative that you adjust your offer at this point to reflect the new information you've learned.

If you must reduce your offer at this point in the acquisition process, you want to make sure you are very clear about the outstanding issues and understand the selling owner will most likely not only be defensive but might decide that you aren't the type of people they want to sell their business to. So, you will want to handle this part of the negotiation if necessary very gently.

Due diligence is done and you are now getting ready to set a closing date to take over the business. Before you do that, you must draft legal documents that clearly state what you are buying, what the seller is promising that you will get and what will happen if the promised events don't materialize.

Remember, the goal of the selling owner is to get as much for their business as they can. If that means they might hide something under the rug that you didn't find during due diligence you will want to make sure you have the opportunity to recoup the cost of lost revenue as a result of promises not kept or information not shared.

This is where the legal documents you draft for a purchase and sales agreement are most important. If sales are warranted at \$1,000,000, you don't want to find out they actually are \$600,000 because during the past year a major account was lost. If you have not documented a method of getting the purchase price reduced because of this, you will be out of luck.

Also, you will want to make sure that you have a method for adjudicating any disputes that might come up in interpreting the purchase and sales agreement. I suggest that put a very strong binding arbitration clause in your sales agreement. This will keep you out of court and help resolve any problems you might have quickly and easily.

*The purchase of the business is now done and unfortunately, John found that a major account had been lost three months before closing that was not picked up during due diligence. Fortunately for John, he not only had this covered in his purchase and sales agreement, but also had a major portion of deferred compensation he owed the departing owner for payment of his business.*

Not only did the salary continuation program allow John to deduct the cost of this part of the sales purchase, but it also gave him funds that he could withhold from the selling owner and not have to place a judgment for the return of money that he may or not might collect.

When it comes time to structure the actual cash paid and the manner it is paid for the business, you will want to hold back at least thirty percent of the purchase price for at least one year and more if possible. Combining a salary continuation program with warranties will automatically allow you not pay owed monies instead of trying to get money you've already paid back from the selling owner.

*John has now completed his transaction. He followed the seven steps and felt that this acquisition would get him to his goals during the next twenty four months. He also felt protected that any mistakes that were made would be his and not from having crucial information withheld from him during the purchase process. Finally, he felt financially protected that since he still owed a great deal of money for the business he would have the ability to collect any money that might be owed him.*

If you follow the same strategies that John uses in his acquisitions, you also will have a higher probability of success when it's time for you to purchase your next business.



For More information contact Josh Patrick  
at 802-846-1264 or email to: [Jpatrick@patrickgroup.com](mailto:Jpatrick@patrickgroup.com)

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**PatrickGroup**

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20 Kimball Avenue - Suite 201 - South Burlington, VT 05403