Legacy M&A ADVISORS LLC

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All Dollars are Not Equal

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Introduction

In the most rudimentary statements about United States Currency, a dollar bill is a dollar bill. The dollar in your right pocket is as equal in value as the dollar in your left pocket. One hundred pennies stored in a jar has the same value as a dollar bill in your wallet or purse. A dollar bill in you bank account is the same measure of value as a dollar tucked in a drawer. Further, a dollar that you earned today carries the same face value as the dollar you earned yesterday. On the other hand, one dollar belonging to your company is not the same as a dollar belonging to you personally.

Why is this? Several potential problems can arise when lending or investing money to or from your own corporation. First, as mentioned above, money is money. Corporate money looks no different from a dollar owned personally and therein lays one problem. Second, the legal position of a company dollar and a personal dollar are different. Finally, the tax positions of the dollars are different moving from personal dollar to corporate dollar.

The purpose of this publication is to explain the potential problems that must be taken into consideration whenever anyone loans money to his/her own corporation or takes a loan from his or her own corporation. Here are three situations:

The Common (Day-to-Day) Scenario

The most typical situation involves an owner who loans money to his/her corporation in order to keep the corporation afloat and has no real intention of receiving the funds back until or unless the corporation has excess funds that it does not need for operating purposes. In situations of this nature, legal documents may or may not be prepared. Unfortunately the Internal Revenue Service has a policy of reclassifying the debt as equity. This reclassification results in the loss of the company's ability to repay not only the principal of the loan but also any interest due on the loan. For accrual basis taxpayers, even the interest that is accrued must be reclassified as equity. As a matter of fact, the government states that any funds paid to the stockholder that are said to be interest payments will be reclassified as dividend distributions. In such a

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A CASE STUDY

The Eleventh Circuit Court of Appeals has upheld an estate's value of a decedent's interest in a closely-held company that was determined by reducing the company's value by the entire amount of the built-in capital gains tax liability. In this case, the decedent owned a 6.44% interest in a closely-held company, which at the time of the decedent's death, had $51 million in potential tax liability.

In valuing the decedent's interest, the estate reduced the value, dollar-for-dollar, by the amount of the liability, as done by courts in previous holdings. The Court upheld this method stating that it was logical to assume that the liquidation of the decedent's interest occurred on the date of the decedent's death. The value was also given a 10% lack of control discount and a 15% lack of marketability discount.

reclassification, the corporation will lose any tax deduction that it might have obtained if the payment to the stockholder had been shown as an interest payment on the loan. Further, the stockholder still must pay taxes on the receipt of the dividend distribution.

The same outcome is typical when there is a lawsuit of the corporation of the individual or corporation. Without records in place, simply stated, one dollar looks the same as another dollar. Creditors are at liberty in these situations when the required records are not present.

Second Situation: Debt Forgiveness

An alternative to repayment of a loan occurs when the stockholder forgives the debt and does not receive any funds back from his/her company. . In addition, a situation may arise where an individual realizes, subsequent to loaning money to his/her company, that the company may never have the ability to repay the funds. Many times the stockholders forgive the corporation from repaying the debt. The tax consequences of this situation depend upon the relationship of the creditor to the company.

Structured as a Valid/True Loan

When an individual loans money to a privately held company AND receives proper authorization from the company's Board of Directors supported with legal documents, i.e. loan papers, corporate resolutions, and a schedule for repayment, the law generally allows the loan to remain on the books of the company as a valid third party obligation. The financial accounting records will show a debt from the corporation to the individual. Interest will be deducted by the corporation and will be taxed to the stockholder upon receipt. Finally, when the principal of the loan is repaid, whether it be in installments or a lump sum, the corporation does not obtain any tax deduction, nor does the stockholder report any income upon a return of his/her funds.

Conclusion

Obviously, readers should be cautioned when they loan money to their corporation. Any loan between a business owner and his or her company should be purposefully structured as a valid and true loan. In other words, there should be 1) proper legal documents drafted, 2) a definite payment schedule created together with 3) a company resolution. The courts, over the years, have identified many factors to be considered in reclassification of the transaction.

Most small business owners, hampered by day-to-day operations, are currently fostering loans on a blasé or even inadvertent basis. Those who have loaned or taken a loan from their company in such a manner should be *concerned and should resolve the potential problem before it becomes an actual one.*

Dr. Bart A. Basi is an attorney, CPA, and the Senior Advisor of The Center for Financial, Legal & Tax Planning, Inc, a full service company specializing in financial, legal & tax matters. Basi is a nationally recognized author, lecturer, and advisor on how to structure deals to minimize taxes. Tax structure makes the difference between getting the deal done and watching the deal fall apart. Many of you may be familiar with Basi and the topics he covers in the Financial, Legal & Tax Advisory which may be read in various industry-specific trade publications.

Points of Interest

- **A dollar bill in you bank account is the same measure of value as a dollar tucked in a drawer.**
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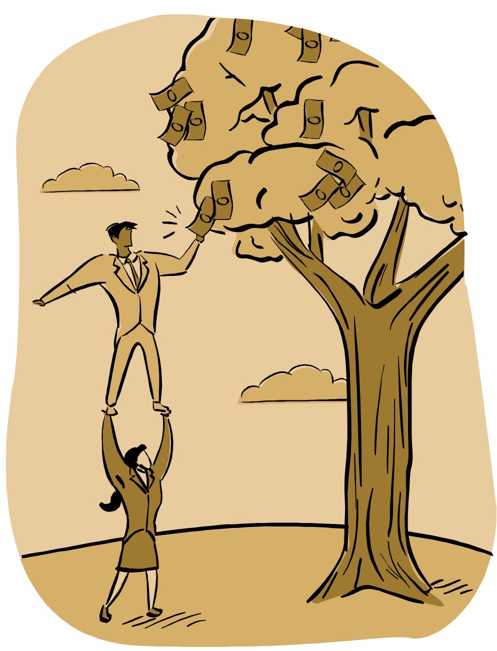
- **Most small business owners, hampered by day-to-day operations, are currently fostering loans on a blasé or even inadvertent basis.**



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A CASE STUDY CONTINUED:

Editor's Comment: There are many different methods for valuing an interest in a company, depending on the particular set of circumstances involved. It can be a difficult process to navigate, which is why such a job is usually performed by professionals. The professionals at The Center have vast experience in valuing closely-held companies. Contact the Center for all of your valuation questions and needs.

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VALUE DRIVERS TO MAXIMIZE THE SELLING PRICE OF YOUR BUSINESS – PART 3

This is the third in a series of articles outlining the steps any business owner can take to maximize the value of his/her business when it comes time to sell. If you'd like to see previous articles in this series, visit our website at www.lmaallc.com. If you'd like a copy of the complete list of value drives, e-mail me directly at mertel@lmaallc.com and request the Value Drivers list.

7. Clean Books & Records

There was a time when buyers and lenders would accept the seller's list of add backs almost regardless of how lengthy or convoluted, so long as they were well documented. Today, buyers and lenders are much more critical and selective, and sellers would be well advised to begin cleaning up their books, records and add backs a couple of years in advance of the date they would ideally like to sell, so the years that will receive the most attention will be reasonably clean.

8. Current AR's, AP's & Inventory

Bottom Line: Buyers will not pay full price for past due receivables, or last season's inventory. All businesses would do better if they kept their receivable, payables and inventory current. If your business has any of these issues, you would do well to convert this out-of-date inventory and receivables to as much cash as possible prior to putting your business on the market.

9. Anticipate & Prepare for Buyer's Due Diligence

Most of my selling clients tell me that the due diligence phase of selling their business was the most nerve racking and upsetting to them, because of the potential of turning up something that might scuttle the whole. A good bit of this can be minimized with proper planning. By anticipating what questions the buyer will have and what documents he/she will want to review, and gathering and screening these items in advance, a lot of the suspense and mystery can be minimized/eliminated.

10. For the Right Buyer, Be Prepared to Carry Some Seller Financing

Almost without exception, sellers would prefer to get 100% cash up front when they sell their business. In my experience, however, when a seller insists upon those terms, it tends to make both the buyer and the lender needlessly wary, sometimes to the point of negotiating a deeper discount to the asking price. Even before the financial market meltdown of late last year, many SBA lenders were requiring the seller to carry at least 10% of the purchase price in a seller's note. When you're reasonably confident that you've met the right buyer for your business, you might seriously consider carrying some seller financing as a sure-fire way to lubricate any bank financing. After all, aren't you more likely to come out ahead if you get 100% of your asking price with 90% cash at closing PLUS a 10% seller's note, vs 100% cash at closing but only 90% of your asking price?

To be continued…

If you know of someone who's thinking of selling or buying a business and who might benefit from a free, confidential, consultation with us, have them contact me at:

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Frequently Asked Questions…

Q: Now that the Supreme Court has upheld The Patient Protection and Affordable Care Act, how will this affect my business in the years to come?

A: First off, the PPACA is a law that is workable for business owners to deal with. It requires business and tax planning like most laws do, but the law is manageable. Of most immediate concern is the 3.8% additional tax on incomes above $250,000. While many people do not earn this level of income, those buying and selling their businesses should be cognizant of this additional tax as it typically causes their income to spike.

Q: How can this income spike be avoided?

A: With proper planning, income spikes can be avoided on the sale of a business. What comes to mind first are the usage of like kind exchanges where possible and the use of installment sales can be used to smooth income. There are other tools in the chest and can be used to smooth income over a period of years.

Q: As far as selling a business or appreciated assets, is 2012 a better year to close as opposed to 2013?

A: The year 2012 is certainly a better year to close in as opposed to 2013. With the low tax rate, business owners are better advised to close business sales this year as opposed to next when higher capital gains rates apply.

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