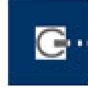

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Dude, Pay Your Business Taxes

By Mark Pittman

Evading Taxes Can Devalue Your Business When it's Time to Sell!

Writing off personal expenses in the company ledger and failing to report cash transactions are common with smaller companies. The fact misappropriated expenses are rarely detected by the IRS has led many business owners to treat this as a condoned business practice.

Such accounting practices however, can backfire when it comes time to sell your business. This is because the failure to pay taxes may dramatically decrease the value of a business. Now let's examine the impact that tax problems can have on the sale of a business, as well as what business owners can do now to maximize the price they will receive when the time comes.

Typically, large companies have developed extensive tax policies and procedures, and have capable executives on board to implement the policies. Tax problems arise most often with owner-operated businesses, including family-owned enterprises. Accordingly, this article will focus on small and middle-market companies that are owner operated.

There are two primary methods used to decrease business taxes:

(1) The under reporting of revenue.
(2) The over reporting of expenses.

The first, which is most closely associated with businesses involved in cash transactions, occurs when cash is received and not recorded. The second method most often involves charging personal expenses to the business. These expenses range from questionable meal, travel and entertainment charges to expenses that are clearly not permitted, such as charging a spouse's car, nannies or home remodels to the business. Regardless of which method is employed, the result is the same: earnings are decreased, sometimes dramatically, and taxes are underpaid.

While manipulating a company's books may result in short-term tax savings, when the business is sold there can be unforeseen consequences.

The consequences can be generally classified into three categories:

(1) The purchase price for the business will be decreased.

(2) The buyer may not be able to obtain financing for the transaction, thus putting the entire transaction at risk.
(3) The owner may be denied the benefit of long-term capital gains tax treatment.

Impact On The Purchase Price

With regard to the reduction in purchase price: For every dollar of tax savings the seller achieves through underpayment of taxes, the seller will receive a much greater reduction in the price paid for the business. This is because when a private business is sold the buyer generally pays a multiple of earnings (or more accurately, EBITDA – earnings before interest, taxes, depreciation and amortization).

The multiple varies by industry and by company attributes. For example, one company might be valued at 3 times earnings while another is valued at 7 times earnings. This means that for every $1 in earnings, the sellers will receive somewhere between $3 and $7. Accordingly, for every $1 that earnings are decreased through accounting manipulations, the purchase price will be decreased by similar multiples. Thus, under this scenario, if a company earns $3 million a year, but the tax returns only reflect $2 million in earnings, the purchase price could be decreased by as much as $7 million.

In order to avoid this precipitous drop in the purchase price, sellers will often "recast" their financial statements. Typically, a seller will add unreported revenue and add back questionable expenses in order to increase earnings and therefore the price for the business. However, even if the financials are recast, the seller must be able to support the numbers with accounting records. Often, business owners are not able to provide sufficient records to support their claims, and the buyer will seek to reduce the purchase price. Furthermore, even when recast numbers can be supported with accounting records, buyers often discount the recast earnings, resulting in a lower purchase price.

Impact On Third Party Financing

One reason that buyers can discount recast earnings is because banks usually will not lend against recast financial statements. Instead, many financial institutions, including the SBA which funds a high percentage of small business acquisitions, will only lend based upon tax returns. Accordingly, if the seller's tax returns show reduced earnings, then the buyer will not be able to borrow as much from the lender, and will either reduce the purchase price, require the owner to carry a note, or cancel the transaction entirely. As a result, even though the recast numbers are correct, the seller will still receive less for the business, and may not be able to sell the business at all.

Impact On Deal Structure & Tax Benefits

Another problem created by improper tax accounting is that it can adversely affect the structure of a transaction. Businesses are generally acquired through one of two structures, either an asset purchase or a stock purchase. In an asset purchase, the buyer assumes the assets and select liabilities. In a stock purchase, the buyer acquires the stock of the company.

In the event of a stock sale, the seller usually can receive the benefit of long-term capital gains, which typically reduce the taxes that the seller pays. Often, this benefit is significant. On the other hand, for the buyer a stock purchase can have several disadvantages. One disadvantage is that the buyer can be held liable for all of the seller's tax liabilities. If tax authorities discover that the seller has not paid all of its taxes, the buyer can be forced to pay them, including penalties and interest. Naturally, when a buyer realizes that a seller has not properly accounted for taxes, and a material liability may exist, the buyer may refuse to structure the deal as a stock purchase. Thus, the seller will not receive the benefit of capital gains tax treatment. In more extreme cases, the buyer will determine that the potential liability outweighs the benefits, and will pass on the deal entirely.

A business owner who anticipates the future sale of a business can implement a plan to avoid the problems set forth above. First, business owners should institute and adhere to tax policies and procedures for several years, and at a minimum for one year prior to the planned sale of a business. Typically, this will involve setting up a reliable accounting system, often with the guidance of an outside accountant. In addition, a business owner will need to retain skilled bookkeepers to record daily transactions, and an accounting firm to prepare tax returns. In the event that a sale is imminent, the business owner should work closely with a sophisticated investment bank to recast financial statements with due care and consideration in order to accurately reflect the company's higher earnings.

Whether or not the sale of business will result in a successful transaction will greatly depend on the degree of planning. If a plan is put in place to handle tax issues, a business owner is more likely to obtain a higher price, minimize risk, obtain a favorable deal structure, and ultimately close the deal.

Mark Pittman is the managing director of Grandview National Inc., an investment bank that focuses preparing businesses for sale and on the sale of businesses valued at $1 million to $50 million, a market that is underserved by traditional investment banks and business brokers. Mr. Pittman is a former CPA and corporate attorney. *All rights reserved, Grandview Holdings, Inc.* *6701 Center Drive West, Suite 710 Los Angeles, CA 90045 T: 310.499.4810 F: 310.499.4820.*