Cohen & Co®

7 Questions to Ask Before Selling Your Closely Held Business

TABLE OF contents

Intro 3

1. What Type of Liquidity Event is “Right?” 4

2. Is Selling to an ESOP Worth It? 8

3. What is the True Value of My Company? 11

4. Is My Financial House in Order? 15

5. Why Do We Need a Pre-Emptive Due Diligence Team? 17

6. What Is the “Best” Deal Structure to Minimize Taxes? 19

7. How Will the Sale Impact My Personal Income Tax and Cash Flow? 22

Conclusion & Contact Us 23

As a business owner, you've likely dedicated a significant portion of your life to nurturing and growing your business into a success. And now, regardless of the reason — and there are plenty — it's time to sell. What are your next steps? What are the best practices to understand before diving in head first?

Selling a closely held business is an intricate process and a significant milestone, requiring careful planning, strategic decision-making and a comprehensive understanding of the complex landscape of the transaction world. Whether you are a seasoned entrepreneur or a first-time business owner, embarking on the journey of selling your business can be both exciting and daunting.

Selling a closely held business is an intricate process and a significant milestone, requiring careful planning, strategic decision-making and a comprehensive understanding of the complex landscape of the transaction world.

Some of your initial questions will revolve around how to convert your ownership equity into liquidity. You'll need to consider the value of your company in the current marketplace, the state of your organization's accounting records, the need for pre-emptive due diligence and the best deal structure from a tax perspective. On a personal note, how will the sale impact your personal income tax and cash flow?

A solid advisory team of accountants, corporate bankers, attorneys and financial advisers will guide you through the process, but going in with a fundamental understanding of key considerations will help empower you to be an integral part of the team determined to maximize the value of your sale.

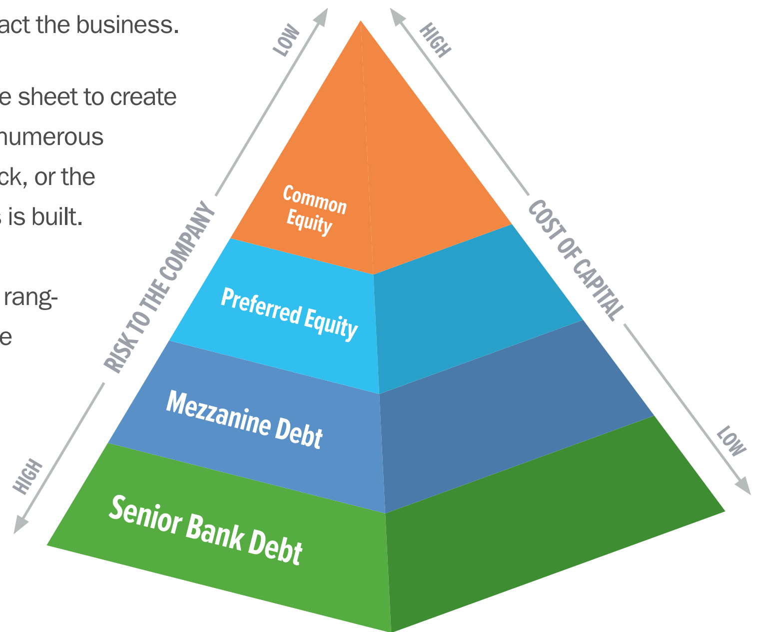
1 What Type of Liquidity Event is “Right?”

The most common ways to convert your ownership equity into liquidity.

As a business owner, your personal wealth is likely concentrated in the equity ownership of your company — meaning your financial security is largely dictated by the company’s performance and continued success. This exposes you to a large amount of risk should any unfavorable events, such as recession, competitive factors or loss of key personnel impact the business.

So, how do you “de-risk” and diversify your personal balance sheet to create more financial stability for you and your family? There are numerous alternatives, all of which will alter the company’s capital stack, or the proportion and sources of funding upon which the business is built.

The pyramid demonstrates five common funding sources, ranging from senior bank debt to common equity. Each of these sources can provide liquidity to an owner; however, the decision of which source to tap into brings with it a set of advantages and disadvantages, risks and benefits.



Choosing which source to use is often quite personal, as it can involve giving up various degrees of ownership in your life’s work. To make the most out of this complex decision, a foundational understanding of each alternative can help bring clarity to the best course for you and your business. Below are some of the most common liquidity alternatives, funding sources and considerations for each.

Senior Bank Debt

Bank loans are the most common method of debt financing. They are the least complex liquidity alternative and the easiest to forecast future impacts on the business. Senior bank loans alter the capital structure of the company by reducing equity and increasing debt. The funding raised by incurring additional bank debt can be distributed to the owner in the form of a one-time dividend. This process is called a leveraged dividend recapitalization.

It is important to consider that if your objective is to reduce personal risk, a dividend recapitalization financed by a senior bank loan that is secured by a personal guarantee does not accomplish this objective. The dividend you are paid is, in effect, still tied to the financial success of the business. Therefore, even though you receive cash and can diversify into other investments, your new assets are still subject to the risks of the ongoing business. Bottom line, funding a dividend with a guaranteed facility likely isn’t a good option.

Adding debt to the capital stack also magnifies the return on equity and provides a tax advantage to the company in the form of interest expense deductions. The fixed payment amortization of the loan provides certainty over future requirements. However, this can be a disadvantage if your business has inconsistent cash flows. When payment is due, the bank has priority to collect, subjecting the business to default risk.

Due to their accessibility and affordability in comparison to equity, senior bank loans are a popular first choice because they are the lowest cost and, therefore, have a place in any company's capital stack.

Mezzanine Debt

Mezzanine debt falls between senior bank debt and equity financing in the capital stack of a company. Unlike bank debt, mezzanine does not require principal amortization payments. Rather, mezzanine debt provides owners with more flexible repayment options, such as:

- Cash interest;
- Payment-in-kind, where interest accrues but is not required to be paid in cash; and
- Principal payout.

Mezzanine debt may also contain equity warrants, which can enhance the return for the lender through equity participation rights. Lenders with equity warrants share in the upside of a future transaction, such as the sale of the business. Equity warrants, from a lender's perspective, can mitigate some of the risk associated with the financing provided in a less secure part of the capital stack.

While the cost of mezzanine debt is less than the cost of equity, the yield required by investors is higher than that of bank debt, generally around 12-14%. However, first time borrowers of mezzanine debt can benefit from institutional ownership of the security, as the reputational impact can enhance the equity value of the company in subsequent transactions. Because principal payments are not due until maturity, mezzanine debt is often called "patient debt," as cash flows are not allocated toward repayment of principal and can fund growth prospects of the business. The liquidity and tax advantages of mezzanine debt still apply; however, mezzanine can be viewed as more beneficial to the growth of the business.

Minority Equity

Moving further up the capital stack, minority equity is the sale of any amount less than 50% of equity ownership in a business. The process of raising equity is much more complex than debt financing due to the many different structures and dynamics of the deal. With equity, much more is at stake. You are giving up some control in the business, meaning elements such as liquidation preferences, dividend rights, participation rights and redemption rights are all important factors to consider in the deal structure.

Finding the right investor is a crucial step in the process. To do so, you must first ask yourself what you are looking for in an investor, and what they bring to the table. Does the investor bring value-add experience, relationships or ideas to the business, or is the investor simply bringing their money to the table? Is the investor someone you want to work with, or would you prefer an investor who takes a more hands-off approach? No matter the decision, the investor should fit your needs and wants as the owner, and ultimately should align with the objectives for the business.

The largest advantage of minority equity is the diversification of your individual balance sheet. The sale provides liquidity to shareholders to diversify while simultaneously reducing the concentration of your personal assets in the business. Minority equity may be best suited if you are looking to still be heavily involved in the business but want to begin to diversify and de-risk your personal portfolio. A dividend recapitalization funded by minority equity does not impact the future cash flows of the business, since there are no associated debt service payments.

Finding the right investor is a crucial step in the [equity sale] process ... ask yourself what you are looking for in an investor, and what they bring to the table.

Raising minority equity means you forgo at least some control over the ultimate direction of the company. Equity sales can also be the most difficult alternative for an owner, particularly one in a long-standing family business. To some, the thought of giving up a piece of their life's work can be a challenging prospect to consider.

Control Equity

While minority equity gives up some interest in the company, control equity represents a more substantial sale — over 50% of the business. At this point the buyer becomes even more crucial, as the future direction of the business is now in their control. Selling control equity may be appropriate if you are looking to transition from management, significantly diversify your portfolio and pass on your legacy to the next owner.

Control equity is not only beneficial in terms of offering more liquidity, but this type of equity also lends itself to more favorable valuations. Buyers will place a premium on the ability to control the future direction of the business. Yet, you as the owner still share in some upside potential of the company through the remaining minority equity. Additionally, to ensure alignment with the future success of the business, many buyers typically require "rollover equity," which is money from the sale you will be expected to re-invest in the business post transaction.

With some financial stake left in the business and control over decisions relinquished, you will be subject to the decisions of the new equity holders. If your company is your life's work, working "for" the new owners can be challenging.

Employee Stock Ownership Plan (ESOP)

One lesser-known but worthy option for liquidity as you look to transition out of the business is to sell to an Employee Stock Ownership Plan, or ESOP. An ESOP, which is a qualified defined contribution plan set up as a trust, allows a company's employees to buy portions of the company by acquiring shares of stock.

As a succession plan, this structure allows owners to sell their shares to the ESOP, providing a market for their stock and ensuring a smooth transition of ownership to employees who are already invested in the company's success. An ESOP can be a powerful recruitment and retention tool, and also has significant tax benefits for both the company and its employees.

However, reduced liquidity compared to other transactions, coupled with increased complexity and cost, and financial risk and compliance requirements are issues to keep in mind when considering an ESOP as a next step. This complex option is covered in more detail in the next section: "Is Selling to an ESOP Worth It?"

Business owners have a challenging job of balancing day-to-day operations while also considering strategic objectives for the future of the business. While operational issues remain a priority, taking the time to consider liquidity alternatives, including the "why" and "when" of each, can greatly benefit you when approaching a transaction.

Whether you are looking to de-risk, gain liquidity, grow or exit the business entirely, each alternative provides certain advantages and disadvantages to achieve your objectives. Starting with a high-level understanding of the alternatives, risks and benefits can help you decide what questions to ask, and when. Working closely with transaction-focused advisers can help you model various scenarios and further explore the alternatives as they relate to your unique situation.

2 Is Selling to an ESOP Worth It?

Explore the pros and cons that go along with it.

As discussed in the previous section, there are many ways to diversify your personal balance sheet that will help ultimately diversify your risk in the company. An ESOP is one of them, although it requires additional analysis due to its complexity. From a business perspective, there are a couple key objectives of an ESOP. It allows:

- Owners to obtain liquidity, while also maintaining certain responsibilities within the company if they desire; and
- Employees to be more vested in the success of the company.

But there are many factors to consider when determining whether to sell your company to an ESOP. Below addresses the different types of ESOPs, and the primary advantages and disadvantages of using one compared to other types of sale transactions.

Nonleveraged and Leveraged ESOPs

There are two types of ESOP transactions to be aware of: nonleveraged and leveraged.

A nonleveraged ESOP does not borrow money to acquire the shares of the seller. Instead, the employer will contribute the shares or cash to the ESOP on behalf of employees. This allows amounts to be allocated to the employees, where employees will "cash out" upon termination or retirement.

A leveraged ESOP is one in which the ESOP borrows money to buy the stock from the seller. This may be in the form of a note between the ESOP and the employer, or the ESOP and the seller. The shares of stock are then allocated to employees as the loan is paid down. In both instances, the ESOP trust will own the shares while the employees participating in the plan receive the related benefits. A trustee is also required, acting as a fiduciary of the ESOP, to ensure the company acts in the best interests of the plan and its participants.

The administrative requirements and expenses [of an ESOP] may outweigh the potential benefits … [or it] could create a win-win situation for all.

Why You Should (or Shouldn't) Sell to an ESOP

Consider these pros and cons of selling to an ESOP.

✔ ADVANTAGES

✔ Fair Market Price

The sale to the ESOP is based on a price that is at the fair market value, which allows for sale of the company at a comparable price that would be obtained if the company were sold to a third party.

✔ Tax Deferral Opportunities

If certain requirements are met — including that the ESOP owns 30% or more of the company's shares post transaction, and the selling owner invests the sale proceeds into a qualified replacement property — selling shares of a C Corporation can allow the owner to defer certain taxes.

✔ Tax-Exempt Status

ESOPs are not taxable entities, and when coupled with S Corporation status, the percentage of the company an ESOP owns is exempt from taxes. That status positively impacts overall cash flow and defers taxes on appreciation of the share price until the participant retires or leaves the company, requiring a repurchase of the shares. Note that while federal taxes are eliminated, the company still must pay property taxes and certain state and local taxes depending on the jurisdictions in which the company operates.

✔ Substantially Reduced Tax Burden

The most significant benefit of an ESOP transaction occurs when the company is an S Corporation and the ESOP owns 100% of the shares of the company, substantially reducing the tax burden and passing it along to the ESOP, which is tax exempt.

That said, in the case of a C Corporation owning the company, the conversion from a C to an S Corporation can have certain complexities that require careful planning, as the conversion can trigger inadvertent tax consequences. For example, if the company is valuing inventory on the LIFO basis before the sale, the move to an S Corporation would require LIFO recapture, triggering tax amounts due even after the ESOP owns the company.

✔ Employee Motivation

Employee incentives can be incorporated within the ESOP, such as in the form of stock warrants or stock appreciation rights. This can help incentivize management, tying them directly to the annual share price via compensation that is in sync with the growth goals of the company.

✔ Increased Employee Retention and Productivity

As employees will have a benefit that is tied to the overall performance of the company, this often creates a mindset of growth. An ESOP can also aid in employee retention, as the benefits of participating in the plan can increase over time as the share price grows, creating a meaningful retirement vehicle for employees.

✖ DISADVANTAGES

✖ Less Liquidity and More Responsibility

The liquidity obtained from the overall transaction is typically less than what you would receive from a third-party transaction. This is largely because many ESOP transactions are leveraged transactions, involving both bank financing and subordinated seller promissory notes that would be paid to the seller over a period of time. Any seller promissory note is subject to the timing of the pay back, which can be over multiple years, as opposed to a lump sum that could be obtained through a third-party sale.

If the retained management of the company is not successful, the seller may also not realize the full value of the sale of the company. Bank debts taken out to finance the transaction may also require certain personal guarantees. So, while the company may owe the debt, if the company is unable to pay its future debts, the seller may be ultimately responsible.

✖ Increased Administrative Duties and Cost

There are many administrative requirements that come with selling the company to an ESOP. First, you must have a board and a trustee to act as a fiduciary. Annual valuations are required to be performed related to the ESOP stock value, both from an ERISA perspective but also for any financial statement audit or review that is performed in accordance with U.S. GAAP. An ERISA audit may also be required to be performed by an independent accounting firm, depending on the number of participants. A third-party administrator must be engaged to maintain participant accounts. The cost of the transaction itself also involves numerous advisers, which can make the ESOP transaction cost prohibitive.

✖ New Balance Sheet Liabilities

The accounting related to the transaction can be rather complex and result in substantial liabilities on the company's balance sheet. For example, ESOPs can offer incentives to employees through stock appreciation

rights and stock warrants, which derive their value from the underlying stock. As debts are paid down, assuming the company is growing, the share prices would also likely go up, thereby creating a substantial liability in the future depending on how these incentives are written. This can potentially impact covenants as well, depending on your bank agreements.

✕ Cash Flow Considerations

You must carefully consider your company's cash flow with an ESOP transaction. As there can be some notable benefits, such as reduced taxes at the company level, there may be additional bank debt and seller promissory notes that require additional cash outflows in the form of principal and interest. Also, as the value of the company increases, amounts owed for repurchases of shares of termed or retired employees will increase the cash outlays required, including amounts owed in the case of incentives such as warrants and stock appreciation rights settled in cash.

✕ Retirement Account Ramifications

While the hope is that the company value continues to increase, if it falls significantly, it can have a material impact on employee owners' retirement accounts.

Selling your company to an ESOP is not for everyone. It is crucial to involve your tax team prior to a transaction to ensure you consider any tax ramifications well in advance. Depending on the size of your company, the administrative requirements and expenses may outweigh the potential benefits, and an outright sale to a third party may be the best route. However, an ESOP could create a win-win situation for all involved, motivating employees while giving owners the exit they are looking for.

3 What is the True Value of My Company?

Knowing the fundamentals matters.

As a closely held business owner, the value of your business is one of the most important factors in assessing your personal financial health and driving positive outcomes when it comes to your goals. More often than not, a significant portion of your net worth is tied to the value of your business — making that value critical when considering an exit.

Whether a buyer presents you with an unsolicited offer to acquire your business or you proactively conduct a sale process with a team of professional advisers, below are a few foundational elements to keep in mind when it comes to your company's valuation.

Plan, Plan and Plan Some More

Business owners should be thinking about a sale years in advance of executing. Areas such as corporate governance, accounting records and other diligence-related documentation can have a profound impact on the value of the business, as well as a buyer's willingness to structure the deal to your benefit. Always plan ahead for items that can increase the value of the company. Think: What are the drivers of the business, and how do we enhance them? While these will likely be different for each company, consider how you can increase cash flows, without harming the business, and how you can reduce risk in the business.

For example, if your company:

- Does not have a strong accounting system and internal controls, put them in place as soon as possible. A buyer who cannot easily understand your accounting methods or needs to invest in these areas will have concerns. Also, a buyer using debt to make the acquisition may have an audit requirement from the lender. If the company is not auditable because of poor systems, the buyer will need to invest in an upgrade, likely reducing your asking price.
- Invests in new equipment, evaluate whether or not the investment is required to maintain existing operations. If not, then how is the investment going to help the company grow?
- Requires meaningful working capital to run the business, what are you doing to increase efficiencies in this area? Often, businesses have far too much inventory and slow collections. It's important to be as efficient as possible with inventory and collections for a meaningful period of time prior to a sale process.

Know the Value Range for Your Company

Many business owners have an inaccurate picture of their company's worth in the eyes of the market, often thinking the market will pay more than what it will, or vice versa. It is important to be acutely aware of the range of values for your business *before* moving out of the planning phase.

While a full appraisal will provide the most information on the value of your company, as an alternative you can request a valuation analysis on your company. Professional standards allow for the performance of a calculation engagement, also known as a "desk-top appraisal," where the analyst and client agree on only certain procedures to be performed. This enables analysts to

give a seller a useful valuation more quickly than they could via the full appraisal process. The calculation engagement uses the same methods of a full appraisal but generally relies heavily on management inquiry — in areas such as identifying similar public companies to benchmark against, and areas of strength or risk — to determine appropriate assumptions.

As an example, the raw data may indicate that valuation multiples are in the range of four to eight times earnings. However, having an understanding of the company's growth, (true or normalized) margins and other key risk areas will allow the analyst to make a judgment of multiples that should apply.

Deal Terms are Critically Important Later On
Terms often have a significant impact on proceeds. Areas such as seller notes and earnouts are very popular in today's market, but remember, cash remains king! It is also important to understand that valuation professionals state values on the basis of cash or cash equivalents at closing. If the terms of the deal reflect the seller holding a note for an extended period of time at a below market interest rate, then the stated price is higher than value received. In other words, if you are offered $10 million to be paid over 10 years at 0% interest, then you are not selling your business for $10 million. You are receiving less than that amount based on the risk of being paid out over that term.

Common Methods to Value Your Business

Another important area to have a solid understanding of is the valuation methods that are most relevant. For most operating businesses, the focus is going to be on valuing a company based on the income approach, market approach or a combination. Both of these approaches effectively measure value by determining an expected return on an economic earnings measurement, such as EBITDA, net income or cash flow

A significant portion of your net worth is [often] tied to the value of your business — making that value critical when considering an exit.

available to investors. In either case, value is derived from the future benefits of ownership, so the goal is to determine the best way to establish and assess those future benefits. This will largely be driven by data available internally, using budgets/forecasts/projections, and externally, using public companies or transactions that are meaningful for an analysis.

Income Valuation Approach

The income approach to valuing businesses computes the value of the business based on the present value of its future economic cash flows or income. A free cash flow analysis for business valuation purposes will generally consider the present value of the company's future cash flows into perpetuity. The present value is derived by applying a risk-adjusted rate or return as indicated by the market for similar investments.

The selection of the level of benefits to be used in this method should be the one that represents the most probable expectation of future returns for the interest being valued.

Market Valuation Approach

Several methods are available under the market approach, including the Guideline Public Company (GPC) Method and the Guideline Transaction (GT) Method. These methods involve identifying and compiling a population of comparable "guideline" companies that are traded in the public market. Using the company's financial statistics, it is the valuator's role to develop value measures based on the prices at which these stocks are trading in the public market. Once determined, these value measures are applied and correlated to your company's financial fundamentals, with the goal of reaching an estimated value for your company. These guideline methods primarily apply a multiple of some financial metric, such as revenue or EBITDA.

Do you know what you're worth? Or, in this case, do you know what your business is worth? That is the fundamental question you must answer as you contemplate selling your business. Part of being prepared for a successful sale and exit is to answer this clearly — well before you go to market or entertain serious offers — and then reevaluate when you are closer to a sale to understand current market conditions. Conducting your due diligence in the area of valuation will help you achieve your financial goals post transaction.

4 Is My Financial House in Order?

What does it mean to have your books in order before selling? Everything.

When it's time to sell your business, you've likely invested great effort and resources into making it a valuable asset. However, inadequate accounting practices can significantly diminish the perceived value of your business during the sale process. The records you keep will underpin your organization and, if not managed properly, have the potential to upend your company.

However, if done right, your financial records can tell an important story — the story of your business — to any and all of your company's current and future stakeholders, including potential buyers and investors. And that story can make or break the deal you've worked so hard for. Below are 10 ways keeping solid accounting records can increase the profit of your sale.

Offer Transparency

Transparent financial records are a fundamental requirement for potential buyers. Vague accounting records can sow doubt and mistrust, leading prospective buyers to question the credibility of your business' financial health. Creating a clear and air-tight financial "paper trail" is crucial for establishing trust and for a successful sale.

Deliver Reliable Financial Reports

Insisting on solid accounting practices in your organization leads to financial statements that are free from inaccuracies, inconsistencies and discrepancies. That's important, because accurate and reliable financial reporting is essential to help buyers evaluate your company's past performance and future potential. The more reliable your financial statement reporting, the more buyers will view your business as a good investment — helping the deal come to life and potentially even driving up the price they are willing to pay.

Streamline Due Diligence Process

And it is a process. Throughout the due diligence phase, potential buyers will scrutinize your business' financial records to gain a deeper understanding of its operations and financial health. Complete and organized accounting records can make the due diligence process go more smoothly and save time for both parties. This in turn gives you as the seller the upper hand when it comes time to negotiate the sale price.

Ease Fears of Risk in the Transaction

Accurate and complete accounting records can go a long way in easing any concerns about the level of risk associated with your business. Your attention to the financial details of your company signals to potential buyers that you likely have taken care of other aspects of the business as well. This perception can lead to higher valuations and more buyers seriously considering your company.

Make the Deal a No-Brainer for Lenders

Buyers often rely on financing to acquire a business. Lenders, just like buyers, require clear and credible financial records to assess risk and determine loan terms. Strong accounting practices that provide confidence to buyers will also provide confidence to lenders — helping your buyers secure financing and potentially opening up the pool to more buyers.

Help Provide an Accurate Valuation

The value of a business is often based on its financial

performance. So, it stands to reason that solid accounting records will help you accurately calculate the business' worth. You want to obtain the most realistic valuation estimates possible to avoid friction between you and a potential buyer during negotiations.

Gain an Edge During Negotiations

With solid accounting records, you can confidently negotiate from a position of strength, knowing the precise value of your business and having a transparent picture of its financial health. In contrast, poor records may cause you to concede more during negotiations, as you are unable to provide compelling evidence of the business' true value.

Minimize Legal and Tax Risks

Buyers are, for good reason, often wary of assuming potential liabilities. If faced with what they believe to be inaccurate financial records, they may require complex indemnification clauses and escrow arrangements to protect themselves after the sale, which can erode the final sale price. Help your buyer avoid additional exposure by being prepared. For example, have all sales and use tax certificates on file; state and local tax issues are often a significant sticking point during the sale.

Enhance Your Company's Reputation

Having excellent accounting practices will contribute to your company's overall reputation as being a solid and valuable asset in the eyes of potential buyers. Paying attention to financial details will offer peace of mind about the business' overall management and commitment to financial transparency. While somewhat of an intangible, protecting your reputation can result in higher valuations and more buyers who can envision a long-term future leading the company.

Shorten Your Sale Time

The longer your business stays on the market, the more its perceived value can erode, as buyers translate a prolonged sale period to mean underlying problems at the company. Adequate accounting records can expedite the due diligence and negotiation processes, reducing the time your business spends on the market and preserving its value.

To maximize the value of your business — even at the first thoughts of considering a sale — it's essential to maintain meticulous accounting records and adhere to best practices in financial reporting. By doing so, you can increase transparency, build trust with buyers, expedite the sale process, and ultimately secure a higher sale price that truly reflects the value of your hard work and investment.

FROM THE TRENCHES

How to Ensure Your Financial Records Are Sound for Your Sale

One of the most important things you can do to keep sound financial records is keep your books as you go. It sounds basic, but we can't overemphasize it enough. Avoid the all-too-common mad dash close to tax filing deadlines to add in the year's transaction details – and the subsequent struggle to remember what they actually were.

Record your financial transactions while they are fresh in your memory. The reality is, transactions seldom run smoothly. Usually there is some maneuvering of funds to consummate a transaction, etc. The further away you are from the actual transaction, the more distant the memory and the more difficult it will be to properly account for it. While it's tempting to put off the accounting side of the deal to handle other pressing issues, don't fall into that trap. The ability to have the information you and others in your business need to make good decisions begins with accurate books and records before, during and after the sale.

5 Why Do We Need a Pre-Emptive Due Diligence Team?

Hiring one before the sale process begins is key.

Buyers of companies have always performed financial due diligence to confirm the information used to value their acquisitions and to help identify risks, weaknesses and opportunities. However, in recent years, sellers have been increasingly conducting their own financial due diligence prior to marketing the business for sale.

In an endeavor as complicated, important and risky as the sale of a business, pre-emptive, or “sell-side” due diligence helps sellers present their financial data more confidently, effectively and proactively throughout the marketing and sale process. It’s a tool that can help enhance the value of the company and help avoid the risk of lower valuations due to last minute surprises. Below are five benefits of having a third-party team conduct sell-side financial due diligience before you start the sale process.

Maximize Transaction Value

A due diligence report allows you and your team to identify positive EBITDA adjustments and growth opportunities that might enhance the value of the company. Conversely, the report can be used to proactively highlight items that potential buyers may view negatively. This gives your team advanced notice about any weaknesses, allowing you to address them and avoid unfavorable adjustments or unreasonable perceptions of risk.

Streamline the Process and Tell Your Story

The due diligence report is a tool that streamlines the sale process. The report addresses many of the most common, initial financial questions a buyer will ask. Providing potential buyers with a summary of due diligence findings early on helps ensure they won’t have to start from scratch in their own diligence process. And it’s always best to tell your company’s story from your perspective starting at the beginning of the process.

Give Buyers Peace of Mind

If it is prepared by a respected third party with deep M&A expertise and experience, the sell-side due

Pre-emptive, or sell-side due diligence, is a tool that can help enhance the value of the company and help avoid the risk of lower valuations due to last minute surprises.

diligence report provides potential buyers with an additional layer of comfort regarding your financial data. It allows buyers to proceed more confidently during the bidding process, knowing that a reputable outside group reviewed the information, while providing a sense of professionalism to the process. Eliminating the perception of deal risks translates to better valuations.

Save Precious Management Time

As a business owner you aren't able to dedicate 100% of your time to a transaction — and you shouldn't. You still need to run the business during the sale process, and if earnings slip, so will values. The due diligence team saves management time by supporting financial information gathering, answering buyers' questions, and preparing exhibits and negotiations.

Offer Support Through Deal Closing

Sell-side due diligence advisers perform the bulk of their work before your business is marketed for sale. However, these teams stay connected to the transaction through the deal closing date. Your advisers will counsel you on key items that impact cash proceeds at closing, such as purchase agreement language and schedules, net working capital targets and adjustments, indebtedness items and other key deal considerations.

A sell-side diligence report gives you and a buyer peace of mind in what is often a very complex transaction. Your due diligence team's expertise in deal-specific issues and their critical advice and solutions throughout the sale ultimately provide your shareholders with greater deal value.

FROM THE TRENCHES

What Is Net Working Capital (and Why Is It Important)?

Net working capital, also known as working capital, is a financial metric that represents the difference between your company's current assets and liabilities. In short, net working capital is the amount of money your company has available to fund day-to-day operations. It is calculated by subtracting current liabilities (such as accounts payable, short-term debt and accrued expenses) from current assets (think cash, accounts receivable, inventory and prepaid expenses).

Why is it so important to your transaction? Most acquisitions include provisions for a minimum amount of net working capital to be passed onto buyers. So, it's important to isolate this financial measure to ensure you don't encounter any surprise adjustments to the purchase price after the deal has closed. Net working capital is especially important for companies that are cyclical or seasonal. The ebb-and-flow nature of these businesses – and their inventory and accounts receivables – can cause significant fluctuations in cash flow that must be planned for.

6 What is the "Best" Deal Structure to Minimize Taxes?

Choosing the one that works best with your goals is critical.

One of the most dreaded replies from a professional services provider is, "it depends." Unfortunately, that's truly the case when determining the most optimal tax structure for your transaction. There are many variables — tax and non-tax — that go into assessing whether a particular transaction structure "works." From the type of entity you're selling and the sale price you're willing to accept, to the value of your company's tax attributes and the tax rates in effect at the time of the transaction, every scenario is inherently different.

However, while every deal is unique, there are some rules of thumb from which to operate. Below highlights three common tax structuring options to consider: equity sale, asset sale or legal equity/deemed asset sale.

Structuring Your Deal as an Equity Sale

From a seller's perspective, a sale of equity is the holy grail of transaction structures, particularly when there is opportunity to fully or partially defer gain. Assuming you will realize a gain, for tax purposes the biggest draw is that this structure allows you to maximize capital gain treatment, i.e., you will be taxed at a lower rate, and basis will be used to lower the taxable portion of the gain. From a non-tax perspective, structuring your deal as an equity sale is often ideal because it transfers your entity's liabilities (known and unknown) to the buyer. Valuing and negotiating the sale of your entire company, as opposed to individual assets in an asset sale, is also generally much less cumbersome for owners to navigate.

While this structure is often ideal, it's not always perfect. With an equity transaction you may receive a lower sale price, since buyers may feel the need to make up for fewer tax benefits as compared to benefits they would receive in an asset sale. Additionally, a buyer may

FROM THE TRENCHES

Why Section 751 Is Important in the Sale of a Partnership

When the target in a transaction is a partnership, the tax impact between an asset and equity sale is often less significant than in the corporate context due to partnership-specific provisions in the tax code. One such provision is found in Section 751, which requires proceeds a seller receives that are related to unrealized receivables and inventory items be treated as a sale of the underlying property, as opposed to the partnership equity interest.

As a result, an owner of the selling partnership must bifurcate any gain between capital gain, taxed at favorable rates, and ordinary gain, which is taxed at higher rates. While the type of property subject to Section 751 seems straight-forward, there are many nuances that lead to "unsuspecting" areas – such as cash basis account receivables and depreciation and amortization recapture – to be included. When selling a partnership, closely analyzing the target's balance sheet will be important.

request certain indemnities or protections, financial or otherwise, for assuming all your company's liabilities.

Structuring Your Deal as an Asset Sale

For some of the same reasons sellers tend to favor equity transactions, buyers tend to favor asset deals. In an asset purchase, the buyer is simply acquiring the discrete assets of the target, not the actual company, which may leave them with some undesirable assets and attributes. However, there are benefits for sellers. In an asset sale, a seller can be selective about which assets, and even strategic liabilities, it may want to retain for various reasons. An asset sale may allow sellers to negotiate premium prices for and navigate various tax treatments of higher-value items.

On the downside, asset sales can result in higher taxes for a seller, particularly C corporations. An asset sale can lead to more items taxed at ordinary income rates than in an equity sale and the potential for a second layer of tax. Additionally, asset sales can be more complex, as they require the identification of which assets will be included in and excluded from the transaction. Asset sales also require the retitling of assets, if necessary, which can add costs to the transactions for the seller and/or buyer.

Structuring Your Deal as a Legal Equity/Deemed Asset Sale

A legal equity/deemed asset sale is a transaction used to conduct an equity sale for legal purposes and an asset sale for tax purposes. From a tax perspective, the buyer typically requests this structure to obtain stepped-up basis in the assets. From a legal perspective, this type of sale does not require transferring titles to assets and contracts. Generally, this structure is simpler for both parties to implement.

This structure could come at a cost to you as the seller, however, resulting in either two layers of tax or incrementally higher tax rates, as alluded to in the considerations for an asset sale. Careful planning and evaluations of basis may ease this burden if a buyer can make an owner "whole" for the additional tax costs and still receive a net economic benefit due to the basis step-up the buyer will receive.

Whether a corporate or non-corporate entity, finding the right structure is key. The good news is you have choices; take the time to consider them all, holistically, to find the right fit.

FROM THE TRENCHES

Basis Step-Ups in Partnership Transactions

Sometimes there are opportunities in partnership acquisitions to achieve certain results through a sale of equity that may not be available in corporate acquisitions, particularly when it comes to a step-up in basis of the assets. This could be a result of how the tax code treats certain partnership equity acquisitions or elections available to the partnership, such as that found in Section 754.

For example, if a buyer is acquiring 100% of a partnership's equity, they are treated as purchasing all of the assets of the partnership. In situations where the buyer is acquiring less than 100% of the partnership equity, a common way to achieve the desired outcome is for the partnership to make a Section 754 election. This election allows for a basis adjustment in the partnership assets with respect to the interest the buyer acquired. In both of these scenarios, the seller(s) are still treated as having sold equity, despite the buyer getting a step-up in basis, as though they purchased the assets. (See Section 751's impact on the seller of partnership equity on the previous page).

7 How Will the Sale Impact My Personal Income Tax and Cash Flow?

Will you be prepared for life's next chapter?

Selling your business isn't just about the business. That takes center stage of course, but it's also just as much about you, the owner, and how financially prepared you'll be in the next phase of your life. That's where modeling the sale of your business and the impact it will have on your income tax and cash flow becomes critical. Below offers an introduction to the myriad of personal considerations when selling your business.

Preparing for Income Tax Consequences

An income tax projection is key to highlight the impact of all additional ordinary income and capital gains from the sale, and to assist with scheduling when tax payments will be due. Additionally, a projection sets the baseline for further income tax planning that can benefit your tax situation, particularly in the areas of income tax deferrals, income tax deductions and future tax planning.

Income Tax Deferrals

Does your deal involve the ability to earn additional purchase price related to specific company performance, such as customer retention or the payout of an escrow account? If so, some of the income tax on your gain can be deferred until the year in which you collect these additional proceeds. You would elect the installment sale method on your personal tax return and only pay tax currently on a portion of your total gain.

Income Tax Deductions

In a year with large capital gains, you have the opportunity to review your securities portfolio for any capital losses, which can offset your capital gains and result in an immediate tax reduction. If you still like the security, you can repurchase it after a 30-day period.

If you have charitable interests, the year in which you sell is the ideal time to consider funding significant donations, either directly to organizations or to a donor advised fund. The increased tax deduction will offset income in the highest tax brackets.

Future Tax Planning

In years subsequent to the sale, you will be pulling funds from taxable and tax deferred accounts to meet your cash flow needs. Future cash flow can be modeled to ensure the mix of taxable and non-taxable funds is income tax efficient and astute.

Cash Flow and Other Consequences

There are many other non-tax related items to consider after the sale of your business. Updating/creating a financial plan is the first step to help guide you through the cash flow decisions to come. Whether you want to buy a vacation home, help your children or grandchildren with college or home purchases, or fund a charitable trust to meet your charitable goals, a financial plan can become the roadmap to achieving these goals.

Hand in hand with reviewing your financial plan after the sale of your business is the valuable task of reviewing your estate plan. Now that a large illiquid asset has been converted to a liquid asset — business to cash — you will want to review your estate plan to ensure it meets your desires for your heirs after you are gone.

Conclusion

Selling a closely held business is not simply a financial transaction; there is actually nothing simple about it. Planning for your exit is a culmination of your hard work, dedication and entrepreneurial spirit. You should be proud of what you've accomplished and excited about your next chapter, as well as that of your business.

The foundational elements throughout this guide offer a glimpse into only the beginning of this process on which you are about to embark. Use these insights, and those of your closest advisers, to begin the conversation and explore your opportunities ahead!

Contact Us

With a focus on closely held businesses, private equity and portfolio companies, our tax, assurance and advisory teams are dedicated to helping owners and their advisers make the most of their sale — before, during and after the transaction.

Marie Brilmyer, CPA, MAcc
Partner, Assurance
330.255.4348
mbrilmyer@cohencpa.com

Phil Ryan, CPA, MBA
Market Leader, Private Equity
216.774.1120
pryan@cohencpa.com

Jim Lisy, CFA, MBA
Managing Director, M&A Advisory
216.774.1153
jlisy@cohenconsulting.com

Thank You

Thank you to everyone on the Cohen & Company team who contributed to this publication: Alane Boffa, Marie Brilmyer, Mike Demko, Caroline Jiang, Josh Lefcowitz, Jim Lisy, Ken Randazzo, Chris Revnew, Phil Ryan, Samantha Smudz and Robert Venables.

Cohen & Company is not rendering legal, accounting or other professional advice. Information contained in this publication is considered accurate as of the date of publishing. Any action taken based on information in this publication should be taken only after a detailed review of the specific facts, circumstances and current law with your professional advisers. CFA and Chartered Financial Analyst are trademarks owned by the CFA Institute.

© 2024 Cohen & Company

Cohen & Co®

1350 Euclid Avenue, Suite 800
Cleveland, Ohio 44115

cohencpa.com