8 factors that most impact your business' net proceeds

Have you ever heard the phrase **'maximizing enterprise value?'** For many business owners, it's their primary focus as they contemplate a potential business sale. But what if I told you that giving equal consideration to **'maximizing net proceeds'** of the deal could result in more wealth to your family post-transaction? Let's take a closer look at some of the key considerations that drive net proceeds and how they ultimately can generate more wealth for you and your beneficiaries.

1. **Asset sale versus stock sale**—Buyers of closely-held businesses generally prefer to treat a sale transaction as an asset sale for tax purposes. It allows them to receive an accelerated tax benefit (in the form of step-up in asset basis) and transaction year tax deductions. However, it could also mean you (the seller) pay higher income taxes since a portion of the transaction will be taxed as ordinary income based on purchase price allocation to ordinary income assets, the fair market value (FMV) of the assets, and the tax basis of the assets inside the business. It's important to fully understand the differences in tax treatment for each type of sale structure, as well as the increased tax benefit to the buyer for engaging in one type of transaction versus the other.

   By thoughtfully considering these dynamics ahead of engaging in any discussions with potential buyers, you and your team will be better prepared to be upfront in initial discussions and avoid any surprises when you ultimately receive a term sheet and letter of intent (LOI). Several of the factors you'll want to assess include:

   a. Recognize any savings the buyer could potentially receive for an asset sale versus stock sale treatment. Confirm with your tax advisor the potential tax difference in asset sale versus a stock sale to you. Use the two data points in negotiations to best position your case for a higher purchase price to cover the increased tax burden associated with making a tax election or restructuring your entity so the buyer can receive these benefits.

   b. Calculate the FMV of the assets in the business and their tax basis. Also understand the class type each asset would fall into, the ordering rules for allocating the purchase price to the respective classes, and the associated tax treatment of each. As mentioned above, assets can be taxed at ordinary income tax rates or capital gain tax rates in the event the buyer is not willing to compensate you for the increased tax burden. There could be

TRUIST

8 factors that most impact your business' net proceeds

an opportunity to negotiate the allocation of the purchase price in favor of the assets that have higher basis and/or long-term capital gain tax treatment.

c. It's important to align your Truist Wealth post-transaction advisory team with your transaction team—to ensure a thorough understanding of the overall taxation of the transaction. This will allow your personal wealth advisory team to do the following:
   i. Understand your net investable/liquid assets
   ii. Help you craft an investment strategy that maximizes the growth of your net proceeds based on your risk tolerance and financial objectives
   iii. Run an analysis to determine if the liquidity generated by the transaction has the ability to meet cash flow/lifestyle needs
   iv. Understand the timing of tax payments (safe harbor based on 110% of prior year or 90% of current year) to avoid setbacks in investment strategy
   v. Review the tax benefits related to charitable planning, wealth transfer planning, and other strategies which may make sense to implement in the same year as the transaction

2. **Deferred payment structure**—Often in a business sale transaction, there will be payments to the seller that are received in year(s) after the transaction. Generally, these payments take the form of earnouts or seller financing payments. Just like the upfront cash payments received in the year of the sale, these payments will have a net proceeds impact that needs to be reviewed. In the event you have a portion of the sale proceeds structured in either of these manners, the key considerations for the deferred payment structure should include:
   a. Obtainability of the payments
   b. The risk of not receiving payment
   c. Your level of control over the outcome
   d. The period of time and interest rate factored into the payments
   e. The taxation of the payments received in the years after the close of the sale transaction

3. **Indemnification obligations: escrow/holdbacks or representation and warranties**—The allocation of risk between buyer and seller is another key item that will impact net proceeds. For escrow and holdback, the same concerns and considerations relating to deferred payment structures discussed above also apply.

8 factors that most impact your business' net proceeds

Additionally, *'representation and warranties insurance'* is often a popular method for protecting against loss and providing benefits for both buyer and seller. However, the insurance premiums, underwriting fees, and deductibles could all potentially impact net proceeds. In the event representation and warranty insurance is required for the transaction, the following concerns should be reviewed:

a. Make sure the amount of insurance premium and/or underwriting fee are in line with market rates
b. Review of the amount of the deductible and the exclusions to the coverage
c. Determine an appropriate cost sharing of the premium, underwriting fees, and/or deductibles between buyer and seller
d. Decide how long the policy needs to remain effective

4. **Consulting/employment arrangement**—Generally, buyers prefer sellers to remain actively engaged in the business for a period of time after the transaction to help with continuity, integration, customer relations, etc. As the seller, make sure you're comfortable with the time you're expected to stay on, and the compensation for your services. In addition, be aware of the structure of compensation and its impact on your net proceeds. Is it more beneficial to remain engaged as an employee or an independent consultant?

   In the event you structure a deal where you sell your entire interest in the business and don't have any rollover of equity, it's often better to negotiate a separate independent consulting agreement. This will allow you to take advantage of retirement vehicles to minimize taxes and take advantage of tax-deferred growth on your liquid investments inside the plan. You may want to consider cash balance pension plans, solo 401(k) plans, or a combination of retirement vehicle structures. You'll also need to review your health insurance options and assess the difference in cost of benefits for a consulting versus employee arrangement before deciding on the structure of your continued involvement, if any, in the business.

5. **Owner occupied real estate and lease arrangement**—Determining whether or not to retain ownership of any business real estate and/or sell it is a personal decision that you'll need to make based on what you're looking to accomplish. Often, it comes down to a decision as to whether you prefer to increase net proceeds by selling the real estate, or increase net earnings by leasing it back to the operating company.

   a. Keeping the real estate

      i. When you're occupying real estate to operate a business with common ownership, you benefit from the nonpassive treatment of owner-operated rental real estate (which isn't subject to net investment income tax and is allowed to be included in qualified business income to calculate your 20% deduction). This is without regard to the lease arrangement between the common ownership entities. However, when you sell the operations of the business in full, the real estate is no longer owner-occupied

8 factors that most impact your business' net proceeds

and you may lose some of the tax benefits that you enjoyed prior to the sale.

ii. Consider restructuring the lease agreement after the sale transaction so that it's not considered a triple net lease. You can increase the rent to cover the cost related to the change in the lease structure to keep it cash flow neutral. This may allow you to continue to qualify for certain business deductions on the rental income, assuming the other needed requirement are met.

b. Selling the real estate

i. When you sell the real estate as part of the transaction, there's a strong likelihood of leaving some value on the table. Generally, buyers are primarily looking to be in the business that they're purchasing and often less interested in the business of real estate. Consider bifurcating the sale to a strategic third party who's in the business of real estate. They may offer you a significantly higher purchase price for the real estate, as your property could be worth more to their portfolio then to the buyer of your business.

6. Closing indebtedness—The debt obligation on the books of the business goes unreviewed when you're solely focused on maximizing enterprise value. But understand how the debt is being accounted for in the transaction is very important to determining net proceeds. It's often the second or third biggest item that impacts net proceeds. Every potential seller needs to carefully consider the following:

a. Understand the buyer's assumption of liabilities such as accounts payable and/or other liabilities related to future operations of the business.

b. Understand your payoff needs on the related debt (including any prepayment penalties or acceleration in payment terms).

c. Determine any impact to the tax calculation.

Generally, debt payoff doesn't directly impact the calculation of the seller's tax liability. But there are circumstances where an owner might use debt basis to take prior year distributions—and the repayment of that debt could cause a taxable event if subsequent year's income doesn't restore basis. In addition, there are circumstances where the debt payoff reduces the amount of the distribution to the shareholder and the closing liquidation distribution could be less than the shareholder basis, which would result in a favorable tax loss for the seller.

d. Consider opportunities to restructure the debt under more favorable terms. Particularly if the debt obligations are connected to a related party, there may be some flexibility to restructure so you can pay over time and capitalize on any rate arbitrage on the difference between the interest rate on the note and the investment rate of return.

8 factors that most impact your business' net proceeds

7. **Net working capital**—In order to maintain normal operations, buyers will generally require a target working capital calculation to stay in the company upon completion of the transaction. This determination of working capital is often a negotiated item. So it's best to come up with a strategic approach to forecasting working capital needs for the business. This will allow you and your investment banking team to be best positioned to negotiate a working capital amount.

8. **Choice of residency**—We're often asked by sellers if it's financially advantageous to change their state of residency ahead of a transaction. The answer depends on the type of transaction, the ownership structure of the business, the intent of the business owner(s), and the operations of the business. Each has an impact on the calculation of whether a change of state residency will increase your net proceeds. A few factors you'll need to consider include:
   a. Each state has different requirements when determining state of residency. You have to make sure you understand those specific state requirements to change your residency such as:
      i. Number of days outside the state
      ii. Location of primary residence and other personal use homes
      iii. Registration of drivers licenses, primary doctors, other state documents
      iv. Intentions to come back to the current state of residency
      v. Establishing greater connection to the new state of residency.
   b. Understanding the type of transaction will help you understand the benefit of a change in residency:
      i. Stock sale—In a stock sale, you'll be required to pay income taxes on the gain in the state of residence that you've established. Generally, the stock sale will result in the greatest benefit if you establish residency in a 'no income tax' state.
      ii. Asset sale—In an asset sale, you'll pay taxes in your state of residence (if the state has an income tax requirement) as well as the state(s) your business has operations/locations in (based on required apportionment factors such as payroll, sales, and property). A change of residency doesn't remove the requirement to pay taxes in the state(s) the business is operating in. It's important to note, however, that most states offer a resident credit for taxes paid in the state(s) of the business operations to avoid any potential double taxation on income.

While not an all-inclusive list of items that impact net proceeds, these are some of the factors we most often see on transactions and which (together with your transition team) we can help you effectively navigate. The timing of your review of these items, however, will be critical to successfully increasing your net proceeds. It's best to understand as many of these considerations as possible ahead of engaging in any meaningful conversations with qualified buyers or receiving any LOI. This will allow you to set the tone upfront and be confident/prepared before engaging in any formal discussions or receiving any purchase agreement proposals.

Lastly, while maximizing net proceeds and enterprise value are vitally important, they shouldn't be your sole objective. It's just as important to consider nonfinancial aspects regarding what's most important to you personally, and what you wish to do going forward, so your Truist Wealth advisor or Truist relationship manager can align our advice and planning strategies with the goals you have for yourself, your family, your community, and your team.

8 factors that most impact your business' net proceeds

Contemplating a sale at some point in the not-too-distant future? The Business Transition Advisory Group is here to help. Please reach out to your Truist Wealth advisor or relationship manager to start a dialogue.

Authored by:
Erich Holmes, CFP®, CEPA®, EA
Managing Director, Senior Transition Advisor, Business Transition Advisory Group
Truist Wealth

Truist.com/wealth