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Planning an exit strategy for your business

Tips to maximize value and minimize taxes

Every business owner should have an exit strategy that helps recoup the maximum amount for his or her investment. Understanding the tax implications of a business sale will help you plan for — and, in some cases, reduce — the impact on your tax bill. This article will focus on selling your business to a third party. Here are some considerations to help ensure the transition is as smooth as possible.

Maximizing value

Start by obtaining a professional valuation of your business to give you an idea of what the business is currently worth. The valuation process also will help you understand what factors drive the value of your business and identify any weaknesses that reduce its value.

Once you've received a valuation, you can make changes to enhance the business's value and potentially increase the selling price. For example, if the valuator finds that the business relies too heavily on your management skills, bringing in new management talent may make the business more valuable to a prospective buyer.

A valuation can also reveal concentration risks. For instance, if a significant portion of your business is concentrated in a handful of customers or one geographical area, you could take steps to diversify your customer base.

Structuring the sale

Corporate sellers generally prefer selling stock rather than assets. That's because the profit on a stock sale is generally taxable at more favorable

capital gains rates, while asset sales generate a combination of capital gains and ordinary income. For a manufacturer with large amounts of depreciated machinery and equipment, asset sales can generate significant ordinary income in the form of depreciation recapture. (Note: The tax rate on recaptured depreciation of certain real estate is capped at 25%.)

In addition, if your company is a C corporation, an asset sale can trigger double taxation: once at the corporate level and a second time when the proceeds are distributed to shareholders as a dividend. In a stock sale, the buyer acquires the stock directly from the shareholders, so there's no corporate-level tax.

Buyers, on the other hand, almost always prefer to buy assets, especially for equipment-intensive businesses, such as manufacturers. Acquiring assets provides the buyer with a fresh tax basis in the assets for depreciation purposes and allows the buyer to avoid assuming the seller's liabilities.

Allocating the purchase price

Given the significant advantages of buying assets, most buyers are reluctant to purchase stock. But even in an asset sale, there are strategies for a seller

Should you set up an ESOP?

An employee stock ownership plan (ESOP) might be a viable exit strategy if your business is organized as a corporation and you're not interested in leaving it to your family or selling to an outsider. An ESOP creates a market for your stock, allowing you to cash out of the business and transfer control to the next generation of owners gradually.

An ESOP is a qualified retirement plan that invests in the company's stock. Benefits to business owners include the ability to:

- Begin cashing out while retaining control over the business for a time, and
- Defer capital gains taxes on the sale of C corporation stock to the ESOP if certain requirements are met.

ESOPs also provide significant tax benefits to the company, including tax deductions for contributions to the ESOP to cover stock purchases and (in the case of a leveraged ESOP) loan payments. S corporations may avoid taxes on income passed through to shares held by the ESOP.

But there are some downsides, too. For example, ESOPs are subject to many of the same rules and restrictions as 401(k) and other employer-sponsored plans. And they can involve significant administrative costs, including annual appraisals of the company's stock. Contact your tax advisor to discuss if an ESOP is right for your manufacturing business.

to employ to minimize the tax hit. One strategy is to negotiate a favorable allocation of the purchase price. Although tax rules require the purchase price allocation to be reasonable in light of the assets' market values, the IRS will generally respect an allocation agreed on by unrelated parties.

As a seller, you'll want to allocate as much of the price as possible to assets that generate capital gains, such as goodwill and certain other intangible assets. The buyer will prefer allocations to assets eligible for accelerated depreciation, such as machinery and equipment. However, depreciable assets are likely to generate ordinary income for the seller.

Allocating a portion of the purchase price to goodwill can be a good compromise between the parties' conflicting interests. Sellers enjoy capital gains treatment while buyers can generally amortize goodwill over 15 years for tax purposes.

If your company is a C corporation, establishing that a portion of goodwill is attributable to *personal* goodwill — that is, goodwill associated with the reputations of the individual owners rather than the enterprise — can be particularly advantageous. That's because payments for personal goodwill are made directly to the shareholders, avoiding double taxation.

You may need to take certain steps to transfer personal goodwill to the buyer. This may include executing an employment or consulting agreement that defines your responsibility for ensuring that the buyer enjoys the benefits of your ability to attract and retain customers. Buyers may want a noncompete agreement. These are common in private business sales and can help protect the buyer from competition from the seller after the deal closes.

Get started now

Different strategies can help you enhance your business's value and minimize taxes, but they may take some time to put into place. Whatever your exit strategy, the earlier you start planning, the better. ■

Is “Made in America” the right model for your business?

Customer preference for American-made products isn’t new. After strained supply chains due to the COVID-19 pandemic, the decision to move from overseas suppliers to domestic factories may have been made for you. But higher labor rates and overhead costs may cause some “homegrown” products to be more expensive than foreign-sourced products. Will your purchasers balk at the higher price tag?

As 2023 starts, manufacturers and distributors should weigh whether a Made-in-the-USA strategy will help attract customers. Here are some angles to consider to position your business accordingly.

What are the rules?

To claim a product is “Made in the USA,” you must comply with strict regulations enacted by the Federal Trade Commission (FTC). Under the rules, final assembly must take place on U.S. soil and the majority of total manufacturing costs must be spent on U.S. parts and processing. Complex labeling standards may also apply if an American flag or map is used on packaging to imply the country of origin.

A company can make a qualified claim when a product is made in several countries, however. For example, it may specify the percentage of a product’s domestic content or label a product as “Assembled in the USA” instead.

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Compliance with these rules is essential when starting new advertising programs or repackaging with the “Made in the USA” label. False claims are likely to attract an FTC investigation, which could lead to enforcement actions and negative publicity. Violators also may need to modify packaging to comply with the FTC regulations, which can be another costly expenditure.

What are the benefits?

Deciding to have your product “Made in the USA” will undoubtedly benefit domestic manufacturing. Prepare by investing staff, inventory and equipment to meet increasing demand for domestic-made products. Remind your customers about the benefits of using domestic manufacturers. This includes:

Less expensive and more reliable shipping. Tariffs and high shipping costs can make overseas production cost-prohibitive. And volatile foreign political environments may prevent products from shipping on time, leading to production delays.

Domestic labor force. People feel patriotic when they support the U.S. economy and create jobs for American workers. They also want to know that factory workers aren't subjected to unsafe conditions, low wages or other forms of exploitation that the U.S. Department of Labor and domestic labor unions protect against.

Limiting business risks. Intellectual property theft and devaluation of the U.S. dollar are just some of the risks companies face when they outsource production to other countries. Additionally, important instructions — such as product specifications or shipping terms — may be lost in translation when communicating with foreign suppliers.

Product safety. News stories about contaminated plastic and pet food products from China have led to recalls, illnesses and even deaths. Products made under the scrutiny of the U.S. Food and Drug Administration and Departments of Commerce and Agriculture are typically held to higher quality standards than many foreign-made products. Safer materials and products give manufacturers peace of mind that they're not exposing end-users to unsafe products — and themselves to liability claims.

Environmental effects. The U.S. Environmental Protection Agency also requires manufacturers to adhere to strict environmental standards that limit emissions and pollutants. Other countries, including China and India, are making huge carbon footprints today that will harm the environment for many years.

Is it time?

For manufacturers that have used overseas suppliers, deciding when and whether to return to U.S. factories and suppliers can be a tough decision. If you do make the move, consider implementing a marketing campaign that positions your products as American-made, whether you sell to businesses or consumers. ■

It's time to analyze your research expenditures

Recent changes to the tax treatment of research expenditures are having a big impact on many manufacturers' tax bills. The most significant change took effect in 2022 pursuant to the Tax Cuts and Jobs Act (TCJA). It requires businesses to capitalize research and experimental (R&E) expenditures under IRS Section 174 and amortize them over five years (15 years for research conducted outside the United States). Previously, businesses had the option to immediately deduct these expenditures. Given the potential impact of these lost deductions, manufacturers should conduct a study of their research expenditures and consider strategies for reducing their tax bills.

Revisit the R&D credit

One potential tax-saving option is to determine whether R&E expenditures qualify for the credit under Sec. 41 for "increasing research activities" (commonly referred to as the R&D credit). Tax *credits* are generally more valuable than tax *deductions*. While both save taxes, tax deductions lower your taxable income, but tax credits reduce your tax bill dollar for dollar.

Note that the Inflation Reduction Act (IRA) of 2022 expanded the ability of start-up businesses to use R&D credits to offset payroll tax liability. The TCJA allowed start-ups — generally defined

as companies that are less than five years old and have less than $5 million in gross receipts — to claim R&D credits against up to $250,000 in Social Security tax liability. The IRA allows these businesses to claim up to an additional $250,000 against their Medicare tax liability.

Keep in mind that not all R&E expenditures will qualify for the R&D credit. Sec. 174 applies to a broad range of expenditures, including both direct and indirect R&E expenses. In contrast, Sec. 41 is generally limited to only direct expenses.

Analyze your R&E expenditures

Another option is to conduct a study of your R&E expenditures to determine whether any of them can be properly reclassified as deductible business expenses under Sec. 162. Prior to the TCJA's 2022 change, businesses didn't need to worry too much about whether expenses were deductible under Sec. 174 or Sec. 162, because the tax treatment was essentially the same. Now, however, determining the proper classification of expenses can mean the difference between capitalizing them or deducting them immediately.

As you review these expenses, keep in mind that under the TCJA, to be eligible for the R&D credit, an expense must be treated as an R&E expenditure pursuant to Sec. 174. So, it's important to weigh the potential benefits of reclassifying R&E expenses as deductible business expenses against the potential loss of R&D credits.

Consider purchasing software

Another significant change made by the TCJA was to change the tax treatment of software development costs. Previously, taxpayers had the option of deducting these costs as they were paid or incurred.

Now, however, software development costs are treated as R&E expenditures required to be capitalized and amortized under Sec. 174. A potential strategy for softening the tax blow of this change is to purchase software, which is deductible immediately as a business expense, rather than to develop it in-house.

> Under the TCJA, software development costs are treated as R&E expenditures required to be capitalized and amortized under the tax code.

Stay tuned

The requirement to capitalize and amortize R&E costs can have a significant tax impact on certain manufacturers. Be aware, however, that some lawmakers are pushing to delay or even repeal this requirement. As of this writing, these initiatives haven't gone anywhere, but that could change in the coming months. ■

How rolling forecasts can provide more clarity

Over the last three years, economic volatility and supply chain disruptions have provided a stark lesson on the weaknesses of traditional budgeting and forecasting methods. Under the best of circumstances, it's difficult for manufacturers to forecast their performance over the coming year. When economic and market conditions are prone to change suddenly and unexpectedly, a traditional static forecast can quickly become obsolete. That's why many manufacturers have adopted a rolling forecast model.

Static vs. rolling

The problem with static forecasts is that management tends to view them as once-a-year events. Once the annual budget is set, managers may not compare actual to forecasted performance until year end. Even if they do recognize midyear that changed conditions have caused the company to fall short of its goals, they may not have the wherewithal to redo the budget.

With a rolling forecast, rather than setting a one-year budget and forgetting about it, management revisits the budget periodically — quarterly or monthly, for example — and adjusts the numbers to reflect changing circumstances. Let's say you create your budget on January 1, 2023, and your rolling forecast calls for you to budget four quarters ahead. At the end of the first quarter of 2023, you'd revisit your budget, tack on a new fourth quarter (the first quarter of 2024) and adjust the numbers based on current conditions.

Rolling benefits

Benefits of rolling forecasts include:

Improved accuracy. By comparing actual to forecasted performance more frequently, and updating the numbers in real time, your forecasts become much more reliable and valuable as a planning tool.

Increased agility. Updating your forecasts regularly allows you to spot trends early and make necessary adjustments for unexpected events or evolving market conditions before it's too late.

Contingency planning. Some manufacturing processes rely heavily on a particular raw material or component part. Creating "what if" scenarios allows you to see how a sudden price increase or shortage would affect your performance and put contingency plans in place to mitigate the impact.

Automate the process

You may be concerned that switching to rolling forecasts will make the budgeting process more costly and time-consuming. But once rolling forecast processes are put into place, most manufacturers find that they're less disruptive than a once-a-year budgeting process. Budget and forecasting software is available to automate the process. Contact your financial advisor to determine if a rolling forecast is right for your business. ■

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