

the **business owner**[®] journal

expertise for the business owner



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From the Editor

It's tax time. The annual distraction from the real work of running a business. As addressed in the blog post reprint in this issue, we desperately need tax reform. The cost of compliance — in both time and money — is ridiculously burdensome. Our federal and state governments need to move to automatic means for tax collection, such as a flat tax on revenue or increased sales tax on both product and service purchases (to replace our complex income tax).

Yes, doing so would shock the established system and upend the source of living for hundreds of thousands of accounting and tax professionals, but if we could make the transition, we'd gain incredible economic benefits by:

- a. enhancing the productivity of investors (such as business owners)
- b. forcing the tax and accounting pros to seek a means of living that contributes to gross domestic product

But until then, it's tax compliance as usual. So, this issue offers suggestion for making the most (or least) of it. Thank you to the venerable national accounting and tax firm of Grant Thornton for its important contributions to this issue.

The good news? The economy continues to recover. It's a new year with a world of opportunity. Let's make the most of it, together.

Sincerely,



David L. Perkins, Jr.
Managing Editor
The Business Owner Journal



the business owner®

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David L. Perkins, Jr.
DL Perkins, LLC — President
Managing Editor, The Business Owner
DPerkins@DLPerkins.com

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wen-chyuan-chiang@utulsa.edu

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FOCUS: Bankruptcy Law • Debtor/Credit Law
ssoule@hallestill.com

Jean Wilcox, CEO
Ginkgo Associates
FOCUS: Marketing and Advertising
jwilcox@ginkgo.com

This publication is owned and published by DL Perkins, LLC,
5727 South Lewis Avenue, Suite 400, Tulsa, OK 74105
918-493-4900; Fax 918-493-4924
Info@TheBusinessOwner.com

Stephanie Coit, Publisher
SCoit@DLPerkins.com

David L. Perkins, Jr., Managing Editor
DPerkins@DLPerkins.com

John Day, Private Label Sales
JDay@DLPerkins.com

John Maybury, copyeditor and proofreader
mayburrito@goofbust.com

Kathy Piersall, graphic design
kathyp@abluemoonarts.com

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Strategies for Preparing Your 2010 Tax Return

The filing season is here and although 2010 is in the books, it's not too late to employ some smart strategies. Tax law changes enacted the past two years provide some opportunities. The tax experts at Grant Thornton offer the following for owners of small and midsize U.S. companies:

New and of Note

1. *Must itemize to deduct real property taxes.* Congress did not extend the real property tax deduction that was available in 2008 and 2009 for taxpayers who don't itemize. The provision had allowed an additional standard deduction of up to \$500 for singles and \$1,000 for married couples filing jointly. The only way to deduct your 2010 property taxes is to itemize.
2. *Phaseouts of itemized deduction and exemption eliminated.* Business owners with sizeable incomes have suffered in recent years through phaseouts of their personal exemptions and itemized deductions. The good news there is that they have been eliminated in 2010. Taxpayers at all income levels can use their deductions and exemptions in full.
3. *Homebuyer credit.* Congress extended a tax credit for homebuyers in 2010 to include purchases made by September 30, 2010 if a binding contract was in place by April 30, 2010. The credit offers up to \$6,500 for "long-time residents" who owned a home that was their principal residence for five of the eight years before the purchase, or \$8,000 for "first-time homebuyers" who did not own a principal residence in the three years before the purchase. The credit begins to phase out at income levels of \$125,000 for singles and \$225,000 joint filers, and the house can't cost more than \$800,000.
4. *Payroll tax reduction.* Lawmakers enacted a one-year reduction in the employee portion of the Social Security tax in 2011 from 6.2 percent to 4.2 percent. The reduction applies all the way up to the Social Security wage limit of \$106,800, and reduces self-employment taxes for self-employed business owners from 15.3 percent to 13.3 percent. It does not affect the deduction for self-employment taxes. Business owners with employees must be using the IRS's updated withholding tables by February 1, 2011 and must credit employees for any overpaid Social Security tax by March 31, 2011.
6. *Roll over to a Roth.* The \$100,000 income limit on rollovers from an IRA or 401(k) to a Roth IRA disappeared in 2010. This type of rollover allows you to pay tax on the conversion in exchange for no taxes in the future (if withdrawals are made properly). A special provision allows you to pay the taxes on a 2010 conversion in equal installments in 2011 and 2012.

Other Suggestions

7. *Gather proof of your 2010 charitable donations.* Donations to individuals, social clubs, political groups or foreign organizations are not deductible. Qualifying charitable contributions must be documented to be deductible. If you claim a charitable deduction of more than \$500 in donated property, you must attach Form 8283. If you are claiming a deduction of \$250 or more for a car donation, you'll need a contemporaneous written acknowledgment from the charity that includes a description of the car.
8. *Electronic filing.* Filing electronically will speed up your refund and can save you from simple mistakes. Before the IRS accepts an electronic return, it checks for several critical errors. The IRS gives you the chance to correct the problems before it accepts and processes your electronic return.
9. *Check your numbers twice.* Avoid math errors and make sure to get your Social Security numbers right. IRS computers automatically match all Social Security numbers and check for simple math mistakes. If you wrote down the wrong Social Security number for one of your dependents, the IRS will disallow the dependent, recalculate the return and usually send you a brand-new tax bill. Millions of returns also generate math error notices that often come as unwelcome surprises to unsuspecting taxpayers. These problems can be a hassle to unwind.
10. *Don't miss the deadline for filing an extension.* Don't bury your head in the sand if you're not going to get your return filed on time. Filing for an automatic extension with Form 4868 is painless and will spare you penalties for missing the deadline. But remember, extending the filing deadline does not extend the time for making a contribution to an IRA, and it does not extend the time for payment. By the filing deadline, you must have paid at least 90 percent of your 2010 tax liability through withholding, estimated payments and any payment made with your extension. [tbo](#)

Moves to Consider Now

5. *Your 2010 IRA contribution.* If you haven't already made your IRA contribution for 2010, you have until April 18, 2011 to do so. If you don't have an IRA account yet, you can set one up. Contribution limits for 2010 are \$5,000 (\$6,000 if you are 50 years of age or older). Contribution are deductible so long as your 2010 income did not exceed \$109,000 for joint filers and \$66,000 for singles.

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Grant Thornton

Grant Thornton LLP National Tax Office
1900 M Street, NW, Suite 300,
Washington, DC 20036
T 202.296.7800 • F 202.833.9165
www.grantthornton.com
taxconsulting@gt.com

Basics of Tax Planning

As an individual taxpayer and business owner, you often have options as to when and how to complete a taxable transaction. You have the right to choose the timing and method that results in the lowest tax liability. There is nothing wrong or illegal about tax planning or tax avoidance, as long as you don't use illegal means. Illegal means include deceit, subterfuge or concealment in one or more of the following categories. Steering clear of these leaves quite a bit of room to maneuver.

- Failure to report income
- Claiming fictitious or improper deductions
- Improper allocation of income to a related taxpayer in a lower tax bracket

Every tax planning strategy is based on structuring a transaction to accomplish one or more of the following often-overlapping goals:

A. Lower Taxable Income

By lowering taxable income, you lower the amount of taxes due. Many strategies to reduce taxable income will simply delay or defer recognition of income. This alone is valuable, of course, given the time value of money. Other tactics include increasing tax-deductible expenses, moving income to entities that enjoy lower tax rates and finding losses to offset investment gains.

B. Claim All Available Tax Credits

Tax credits are dollar-for-dollar reductions to your tax bill. Deductions are dollar-for-dollar reductions of your taxable income. There is a big difference. Tax credits are much

more valuable than deductions because a \$100 credit reduces your tax bill by \$100, regardless of your tax bracket. In contrast, a deduction simply reduces your taxable income by the product of the deduction amount times the applicable tax rate. For example, if you are in the 33 percent tax bracket, a \$100 deduction will reduce your taxes by \$33.

C. Lower the Applicable Tax Rate

Such strategies include rationalization of taxable income between tax years in light of marginal tax rates; moving income to persons or entities that are taxed at lower rates; moving income into accounts that are non-taxable or tax deferred; or conducting transactions in a way that qualifies for lower rates (such as long-term vs. short-term capital gain rates). See also "Lower Your Applicable Tax Rate" in this issue.

D. Control the Effects of the AMT

The AMT was established in 1986 to ensure that higher-income individuals and corporations pay at least a basic level of tax, regardless of the number of tax credits and deductions that they garner. It requires that federal income taxes be calculated by two separate and distinct methods — regular tax laws and AMT laws. You pay the higher of the two. C-corporations with annual revenues under \$5 million (and in some cases up to \$7.5 million) are exempt. Individual taxpayers who have incomes over \$75,000 face heightened risk of triggering AMT taxes. AMT tax rates are lower, such as 26 percent and 28 percent for individuals, but far fewer credits and deductions are allowed. [tbo](#)

Owner Stock Repurchase Tax Traps

Some very tricky rules apply when a company buys back stock of shareholders or related entities. Recognize that this is a very complex area and get expert advice before effecting any corporate stock repurchase.

Example #1: If the company redeems or buys back part of a shareholder's stock, the full amount paid (not just the profit) to the stockholder may be taxed as a dividend at ordinary income tax rates up to 38.6 percent, rather than at the capital gain rate of 20 percent.

Example #2: If you sell all of your stock back to the company — for example, if you wish to retire — you also must completely sever your relationship with the company for

the next 10 years. Otherwise, the full proceeds may be taxed to you at ordinary income rates. That means you can't be an officer, director, consultant or employee. It's okay, though, to be a supplier or rent property to the company on an arm's-length basis. You may also be able to be a creditor, under certain circumstances.

Again, be sure to consult your tax advisor before you make plans to buy back the stock of any shareholder. The rules are complex and the IRS filing requirements are detailed. More information can also be found in the Internal Revenue Code, Sections 302 and 303. [tbo](#)

TAXES

Managing Marginal Tax Rates (A Basic Tax Reduction Tool)

A key feature of our federal tax system is its progressive nature. Tax rates are higher at higher levels of income. Your marginal tax rate is the rate of tax you pay on your next dollar of taxable income. The rates for 2010 and 2011 start at zero, then go to 10, 15, 25, 28, 33 and 35 percent. You can lower your tax bills by knowing your marginal tax rates and allocating income in a way that minimizes the income subject to higher tax rates.

Example 1: Assume that you've had a good year of income. You are married, file jointly, and determine your taxable income for 2010 to be \$205,000 currently — the

Your marginal tax rate is the rate of tax you pay on your next dollar of taxable income.

total of interest income (\$10,000), salary (\$80,000), commissions (\$40,000) and pass-through earnings from your company (\$75,000). It is near year-end and you are close to completing a sale that will add \$50,000 to your company's net income (and to your pass-through income). Should you push to get it done before year-end or let it slip into 2011?

If we look at the federal tax rate tables found on page 14 of the November/December 2010 issue of this publication, we see that married couples filing jointly pay a 28 percent income tax rate for income between \$137,301 and \$209,250. Income over \$209,250 to \$373,650 is taxed at 33 percent. If the sale closes this year, you will owe a

total federal tax of \$16,288 on the additional \$50,000 of income, computed by applying the 28 percent rate to the \$4,250 left in the 28 percent tax bracket and applying the 33 percent tax rate to the remaining portion of the commission income. But if you delay closing until next year, when you expect your overall income to be lower, the income could be taxed at the 25 percent and/or 28 percent levels, saving you at least \$2,288 in federal tax (assuming the \$50,000 is all taxed at the 28 percent rate), and even more when you include state tax. A nice return, considering how little effort is required.

Example 2: Joe Roe has calculated his taxable income, after regular and itemized deductions, at \$77,000 for 2010. It has been a great year, but he expects his income to be more its typical \$40,000 next year. Using the federal income tax tables for married filing jointly, he sees that he is in the 25 percent tax bracket for all income over \$68,000. As such, he is paying 25 percent tax on \$9,000 of his income. He checks his personal payables for deductible expenses and sees that he is holding a real estate tax bill due March 15, 2011 for \$7,000. Because many real estate taxes are deductible in the year they are paid, and this one is, he could go ahead and pay the bill before year-end and reduce his 2010 taxable income by \$7,000. To the extent that next year's income will all be taxed at the 15 percent bracket, Mr. Roe would save \$700 in taxes, calculating the savings as the difference between the 25 percent and 15 percent tax rates multiplied by the \$7,000 of income that would have otherwise been taxed at 25 percent. **tbo**

TAXES

Q&A: Who Can Deduct Interest Payments?

Question: Several years ago my daughter took out a mortgage to buy a home. I told her that I would help her pay it off. Now I am wondering whether I can deduct the mortgage interest since I've personally been paying the monthly payments. The loan is in her and her husband's name, but they are now separated.

Answer: You have to meet two tests to deduct interest on another individual's loan: (a) You have to be directly legally liable for the loan, and (b) you have to make the payments. From a tax point of view, your arrangement

for the loan repayment is benefiting neither you nor your daughter. She can't claim the interest deduction because she isn't making the payments, and you can't deduct them because you're not legally obligated for the loan payments. You might be better off giving your daughter the money to repay her own mortgage loan. At least then she could claim the interest deduction.

Editor's note: If you co-signed the original note as guarantor, you may be allowed to take the interest deduction. **tbo**

TAXES

Lower Your Applicable Tax Rate

Strategies for lowering the rate at which income is taxed include the rationalization of taxable income between tax years in light of marginal tax rates, moving income to persons or entities that are taxed at lower levels, moving income into accounts that are nontaxable or tax deferred, and

One spouse may gift \$22,000, and as long as the amount is reported and both spouses consent on the return, the amount will not be taxable.

conducting transactions in a manner that qualifies for lower rates (such as long-term vs. short-term capital gain rates).

Allocate Income Among Years to Avoid Higher Tax Brackets.

This technique, known as Marginal Tax Rate Analysis, is explained in more detail in the accompanying article titled "Managing Marginal Tax Rates: A Basic Tax Reduction Tool."

Hold Appreciated Investments Long Enough to Qualify for Long-Term Gains Treatment.

Investments held for less than one year are taxed at ordinary income tax rates, which are higher than capital gains rates. Investments held for more than a year are taxed at long-term capital gain rates, which are lower at all income levels.

Make Charitable Contributions with Appreciated Assets Instead of Cash.

Doing so will save you from owing tax on the capital gain, and you will still be able to deduct the full, appreciated value of the stock (if you have held the investment more than a year).

Gift Money, Assets or Investments to Entities That Enjoy Lower Tax Rates.

Any person can give \$13,000 in cash or property per year to any person or persons, with no income tax or gift consequence to either party. This tax code provision is most often used to move assets to children and grandchildren because the amount transferred will not be subject to estate and/or generation-skipping tax. It is an effective tool for moving income-generating assets to persons who enjoy lower tax rates. As long as the gift is \$13,000 or under, there is no reporting requirement. Additionally, one spouse may give \$26,000 as long as the amount is reported and both spouses consent on their tax return.

Shift Income to Entities Domiciled in Cities, States or Countries with Lower Overall Tax Rates.

City, county, state and federal taxes vary significantly. Businesses that have multiple locations of operation and/or a non-local client base, and even individuals, should consider how taxes could be reduced if income could be attributed to another locale. [tbo](#)

TAXES

Should You Switch to the Cash Method?

The IRS will allow businesses with annual revenue as high as \$10 million per year to use the cash method of accounting. Owners of businesses with revenues below this level that are not currently using the cash method should consider doing so as it generally allows for greater control of when revenue and expenses are recognized. The primary benefit of having such control is ability to delay recognition of income and thus delay when income taxes are due and payable.

To review, two primary accounting methods exist — cash method and accrual method. The cash method is very simple. Revenue is recognized on the income statement when

money is actually received (not when the product is shipped), and expenses are recorded when bills are actually paid (not when the purchase order is issued or the bill is received).

The accrual method is a little more complex, but accounting software has eased the burden significantly. Revenue is recognized when it is earned (i.e., when the sale is made) and expense is recognized when the liability is incurred (i.e., when the purchase order is issued). This method was developed to more accurately report the financial

continued on next page

How to Do the Business Dinner

Relationships are what our personal and work lives are built on. Dining with others provides a one-of-a-kind opportunity to develop relationships. It makes sense to make the most of each and every one. How? It's an art. Knowledge is power.

Nina Zagat has been dining with clients three days a week for 30 years. It's her business. She owns — with her husband — Zagat Survey restaurant guides. In a recent *Wall Street Journal* article, she suggested ways to make the most of business lunches and dinners.

She says the main goal should be to get to know each other on a personal level and have a pleasant experience. "The feeling that (all) the people should come away with at the end of the business dinner is that they've had a really nice conversation, met interesting people and had a good time," she said. To help make that possible, she suggests:

- Select a location that fits your companion's location and culinary preferences.
- Choose a restaurant that is not too loud. Restaurants with smaller rooms and tables that are spread comfortably apart tend to be better choices.
- For larger groups, let the most important guest (not you) sit at the end of the table. Better still would be a round table — they're more conducive to conversation among all.
- When being seated, the host or hostess should ask the guest of honor or business partner to sit at his or her right. When dining *a deux*, just ask your dining partner where he or she would like to sit.

- At a business dinner or lunch you're not trying to draw attention to yourself or what you're eating. The food or drink should not become a topic of focus. Don't order difficult-to-handle foods such as lobster, crab or spaghetti, and be discreet about your own preferences and needs such as food allergies or dietary requirements.
- Don't bring up any hard business-related topics until the entree is served. This leaves ample time before and after the entree for comfortable, non-business chitchat in line with getting to know each other on a personal level and having a relaxing and pleasant time together.
- It's okay to order half portions or offer to share an appetizer or dessert.
- Take care not to appear flashy or spendthrift by ordering, for example, the most expensive entree or wine. In fact, it's a good idea to ask the waiter for a suggestion on a low or moderately priced wine — even asking for suggestions in the x price range — and quietly accept one.
- Acceptable topics of conversation can be quite broad, even including politics. After all, the goal is to get to know each other. If the conversation starts to get emotional or heated, just move to another topic.
- It's okay to pick up a cell phone to refer to a note or email that is relevant to a topic of conversation, but don't leave it on the table and don't let it ring.

Mrs. Zagat's suggestions ring true. She focuses on developing relationships rather than silly rules of etiquette. **tbo**

continued from previous page

performance of a business. Generally, it does so, rendering more useful and informative statements.

But for many businesses, the accrual method causes income to be recognized earlier than it would under the cash method. This can be particularly true in businesses that purchase large quantities of products in advance of customer purchases or payments, such as retailers and contractors. This can cause income tax to become due before cash is actually received from sales, causing a cash flow burden.

The IRS has a long-standing bias toward accrual accounting, and until 2002, required all businesses with revenues in excess of \$5,000,000 to use it. The threshold has now increased to \$10,000,000, allowing some 500,000 additional U.S. businesses the freedom to choose which is best for them. For more information, contact your accountant or tax advisor. See also section 448 of the Internal Revenue Code; Notice 2001-76 in Internal Revenue Bulletin 2001-52; and IRS Publication 538, Accounting Periods and Methods. **tbo**

ECONOMICS

Aftershock

By Robert B. Reich

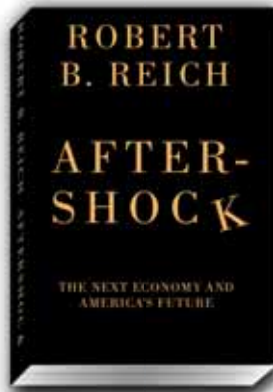
Reviewed by David L. Perkins, Jr.

Robert B. Reich is an economist, professor, author and political commentator. He served in three presidential administrations — those of Gerald Ford, Jimmy Carter and Bill Clinton. A graduate of Dartmouth College (summa cum laude), Oxford University and Yale Law School, Reich is considered one of America's foremost political economists.

He is currently Chancellor's Professor of Public Policy at the Goldman School of Public Policy at the University of California, Berkeley. He was formerly a professor at Harvard University's School of Government and professor of social and economic policy at Brandeis University. In 2008, *Time* magazine named him one of the Ten Most Successful Cabinet Members of the century, and the *Wall Street Journal* placed him among America's Top Ten Business Thinkers.

In *Aftershock*, Reich says economic recovery requires that we get back to "the basic bargain." He says the recession was inevitable because consumer spending is what fuels our economy. The middle class, representing 95 percent of the American populace, is our economic engine. The rich just do not amass enough demand to keep the engine of commerce running. And for the past 30 years, middle-class Americans have been squeezed economically. Wages and salaries have declined in real terms. The middle class has coped by working more hours, incurring more debt, delaying marriage and children, having fewer children, putting

"the other spouse" to work and borrowing against home equity. These efforts kept the middle class spending and enjoying the fruits of "prosperity" to keep the economy growing. But the turnip can be squeezed no more.



Reich says the only way to get back on the path of economic growth and prosperity is more wealth in the pockets of middle-class Americans, more education, stronger social safety nets, more health care benefits and more government spending on infrastructure. And he believes the only way to fund these things is to revise federal tax policy, including more taxes on the rich.

Reich's data show that the great prosperity of the 1950s, 1960s and 1970s occurred when marginal tax rates on the rich were in the 80th and 90th percentile, and government spending was extensive (welfare, Social Security and infrastructure-building).

Reich explains that most Americans think it was lower tax rates ushered in by President Reagan that fueled prosperity and a strong stock market the past 30 years, but GDP rates and stock market returns were higher in the 1950s, 1960s and 1970s.

Reich says the gap between rich and poor peaked in 1928 and again in 2008. We are reliving the past. By returning to "the basic bargain" — supporting a strong middle class and reducing the gap between rich, middle class and poor — we ALL once again can enjoy prosperity. [tbo](#)

EMPLOYMENT AND EMPLOYEES

Unfair Distraction of Employees

Do your employees ever get calls from creditors or collection agencies about their personal financial affairs? Certainly, this hinders their productivity. Did you know that under the Fair Credit Collection Practices Act it is illegal for collectors to contact a debtor at his/her place of employment if the collector is made aware that it is against the personnel policy of the employer for the employee to take such calls?

Smart solution — add to your personnel policy that it is a

violation for any employee to accept a call from a creditor or collection agency about his/her personal financial or business affairs. Communicate such to your employees and make sure they understand that they are to tell any creditors that contact them at work of the company policy, their knowledge of the Fair Credit Collection Practices Act, and that any violators will be reported to the Federal Trade Commission. For a copy, go to: <http://business.ftc.gov/legal-resources/fair-debt-collection-practices-act>. [tbo](#)

Industry Business Valuation Multiples

An owner of a midsize (30-employee) private company recently asked me, “What is the industry valuation multiple for our industry?”

There isn’t one. At least not a credible one. Some advisors, writers and business owners try to peg a multiple for an industry, but it’s rather arbitrary — even silly. At least for companies with less than, say, \$500 million in revenue. Here are the reasons:

1. Factual data about the price and terms at which small and midsize private businesses sell is very difficult to find. This is because the businesses are almost all private and the data are not released to the public. Similarly, the data are not compiled anywhere. There are two exceptions to this:
 - a. When the acquirer is a public company. This will be a minuscule subset for almost every industry. Still, when these transactions occur, some meaningful data can at times be gleaned.
 - b. Some “business brokers” will anonymously and blindly submit their “done deal” data to one of two databases of business sales – BizComps and PrattStats. Although these data are interesting and “worth a look,” few industries have enough data points to allow meaningful extrapolation. More significantly, the data are not reliably inputted. Of course, this doesn’t stop *Inc.* magazine from attempting to compile and annually publish valuation data from these datasets.
2. Businesses sell for a wide range of values for a vast array of reasons. Even if ample quality data were available, they would be of little value.

To illustrate point #2, my firm has proprietary data on five business purchase-sale transactions in the metal heat treat industry.

Here are the summary data:

Selling Company	Multiple of Sales	Multiple of Gross Profit	Multiple of EBITDA
A	1.25	4.39	6.14
B	0.99	.998	N/A
C	0.64	N/A	3.43
D	0.33	1.41	N/A
E	0.71	1.78	N/A

The selling companies’ revenues ranged from a high of \$135 million to a low of \$600K. Only two of the six compa-

nies were profitable. Sale prices ranged from a high of 1.25 of sales to a low of 0.3. For the two profitable companies, the purchase price multiple of EBITDA was 6.1 and 3.4.

Are these data meaningful to the hopeful seller? Well, the range of values is quite large. I guess one could simply shoot for the highest multiples, but this completely ignores the reality of what the market will bear for the particular characteristics of the selling company. Note that Company E in the table, which was not profitable, sold for a higher multiple of revenue than the profitable company C.

If the owner of a heat treat company were offered 50 percent of revenue and 10 times EBITDA, is it a fair price? Should the seller accept it? Again, it depends on the characteristics of the firm. If the subject company has significant revenue that’s growing rapidly, but very low earnings, maybe not. The examples can be infinite.

What if the company that earned the highest multiples in the sample dataset left money on the table because it did not handle the sale in a manner that would yield maximum value?

In short, simple answers to complex questions such as “what price is fair” just don’t serve us well. A credible expert in the purchase and sale of private companies can assess the characteristics of a particular company and estimate market value. Just watch out for firms or advisors that charge large lump sum up-front fees. They have incentive to tell you an inflated estimate to get you to hire them.

Private, profitable businesses that have little or modest growth typically sell for three to five times earnings — depending on the industry, size, proprietary nature of the products and other characteristics of the business. But again, for companies with high or growing revenue and modest profit, these EBITDA multiples may not provide meaningful guidance. High growth can command earnings multiples well in excess of six.

For more data on the drivers of and detractors from value, purchase a copy of *Path to Absolute Maximum Sale Price*, published by Acquisition Advisors. [tbo](#)

“Sales drive our ability to survive and thrive.”

Harvey Mackay

Case Study: Minority Share Buyback

This case study is based on the experience of a business owner who owned 70 percent of his business. The balance was owned by two individuals, one of whom owned 20 percent and was causing much difficulty. The controlling shareholder wished to reacquire the shares of the troublesome stockholder, whose interest was valued at \$200,000. But after working through the numbers, the business owner decided that the cost to the company would be too great. He decided to simply live with the troublesome minority shareholder.

When a corporation buys common stock from its stockholders, the transaction is referred to as a “corporate stock redemption,” and the stock so acquired is called “treasury stock.” Corporate stock redemptions are considered by company owners principally for the following reasons:

1. **Peace:** To silence a troublesome minority stockholder.
2. **Obligation:** For example, one of your executives is leaving the company and he or she has the legal right to require the company to buy the stock he or she purchased previously under a stock option plan.
3. **Mandated Buyout:** When a court of law orders the company to buy out a minority owner’s shares.
4. **Investment.** Management might cause the company to buy the stock from willing sellers because they think it will provide a fair return on investment and raise the value of the shares that remain.
5. **Stay below the 500-shareholder threshold.** Private firms that have 500 or more shareholders can be required to make public filings similar to public companies.

As principal owner of your business, you have to be concerned with any corporate stock redemption, for the following reasons:

- Many states restrict or prohibit the purchase of stock by the company from its stockholders, principally depending on the availability of cash and capital surplus within the company to effect the stock repurchase. Basically, you cannot “impair” the capital account and solvency of the business by repurchasing “equity” securities.
- Other stockholders may complain because of the effect on the corporation, particularly its balance sheet. The operating agreement of the company may also require that such a transaction be approved by some percentage of the shareholders.
- You may be accused of unfair dealing if you don’t offer all owners the right to sell their stock back to the company at the same time, price and terms.

- Your creditors may object since the stockholders’ equity account drops after a redemption. For this reason, most loan agreements prohibit or restrict a company’s repurchase of equity shares or interest.
- You may be sued by the selling stockholder if you know of certain facts that affect the value of the stock and these facts are unknown to the seller (material-insider information) at the time of the stock repurchase.

Effect on the Company

Below is a description of the subject business owner’s analysis, with explanatory remarks. Note that this approach can be applied to companies with other forms of ownership, including S-corporations, partnerships and limited liability corporations (LLCs). Let’s start with the stockholders’ equity account, in which there are 100,000 shares of common stock outstanding.

Stockholders’ Equity Account

Common Stock — \$1 par:	
100,000 Shares Outstanding	\$100,000
Capital Surplus	\$120,000
Retained Earnings	\$280,000
Total Stockholders’ Equity	\$500,000
Book Value per Share	\$5.00
Net Income	\$75,000
Earnings per Share	\$0.75

Let’s also assume that total company debt is \$1 million and that of the 100,000 shares outstanding, 20,000 shares are being acquired by the company (20 percent of the outstanding common stock). The agreed-on purchase price is \$10 per share (two times the company’s \$5 book value per share), which represents a \$200,000 total purchase price. Based on these facts, here’s the result:

- Corporate cash declines by \$200,000 (20,000 shares times \$10).
- Stockholders’ equity decreases from \$500,000 to \$300,000 — a reduction of 40 percent.
- Leverage increases from 200 percent (\$1 million total debt divided by \$500,000 equity) to 333 percent (\$1 million debt divided by \$300,000 equity). This assumes that no additional capital was borrowed to finance the stock repurchase. If that were necessary, the debt-to-equity ratio would have risen even higher.

Effect on Remaining Owners

The remaining stockholders increase their ownership percentages. Since 20,000 shares are in treasury, a stock-

continued on next page

continued from previous page

holder owning 10,000 of the remaining 80,000 shares will now own 12.5 percent of the corporation (10,000 shares divided by 80,000). Before the purchase, this stockholder owned 10 percent (10,000 shares divided by 100,000). The percentage ownership position of all stockholders will increase by 25 percent.

Book value per share declines from \$5 to \$3.75 — \$300,000 pro forma (after repurchase) stockholders' equity position divided by 80,000 shares. The pro forma decline in book value occurs because the buy-back price of \$10 per share was double the previous book value per share of \$5 (\$500,000 stockholders' equity divided by 100,000 shares). That's why other minority stockholders may not be in favor of the transaction — unless they also are given the right to sell shares back to the company on the same terms.

Based on last year's net income of \$75,000, earnings per share would increase from \$0.75 to \$0.94 (\$75,000 net income divided by 80,000 shares). But note that if debt is used to finance the stock purchase, pretax income (and net income) should be adjusted downward to reflect the resulting interest expense. Company cash is being used for nonproductive purposes. This may significantly impact the company's future growth and its profitability and, as explained below, can negatively impact the company's borrowing ability.

Finally, the tax basis of each share of stock owned by the remaining shareholders remains unchanged despite the fact that the value of each share has risen due to the lower number of shares outstanding. When the remaining shareholders sell their shares, as if the entire company were sold, the taxable gain will be greater than it would have been had the buyout of the 20 percent owner been effected by a direct purchase from the shareholders. Such a purchase would have required the shareholders to use personal funds to effect the purchase, but a step-up in the basis of the stock would have occurred and the tax owed in a subsequent sale would be less.

Effect on Company's Value

Since \$200,000 is purchasing 20 percent of this company, the value placed on the business is \$1 million (\$200,000 divided by .20). In terms of fundamental valuation methods, this \$1 million value represents:

- A price-earnings multiple (P/E) of 13.3 times last year's net income of \$75,000.

- 2.0 times stockholders' equity of \$500,000 before the stock repurchase.
- 3.3 times stockholders' equity of \$300,000 after the stock repurchase.

This value analysis is presented to give you additional information to help you in deciding whether or not to effect the buyout. You also will have to determine the value of the company going forward. For example, if this company were projecting net income of \$150,000 next year, the \$1 million value would represent a P/E multiple of only 6.7. This alone could justify the stock repurchase, particularly if the company's growth continues on course.

Access to Capital

The company redemption/purchase of common stock also has dramatic effects on the company's creditors, who now have a lower stockholders' equity account under their debt position, and a debt-to-equity ratio of 3.3 to 1 (\$1 million debt divided by \$300,000 stockholders' equity). In addition, the company's future borrowing capacity is substantially lower. Thus, if you are going to redeem any stock, be sure your overall cash position (today and projected) is more than adequate to finance growth and contractual debt repayments.

What If You, the Owner, Are the Seller?

If you are the owner and your common stock is being purchased by the company, read "Owner Stock Repurchase Tax Traps" on page 4. Proceeds of your sale could be taxed to you at ordinary income rates rather than capital gain rates unless you completely sever your relationship with the company. Also, for liability reasons, make sure that the:

- Stock redemption price is at fair market value as established by an independent appraiser.
- Shares are purchased by the company on an arm's-length basis.
- Acquisition price and terms don't discriminate against other stockholders.
- Tax impact of the sale/purchase on both you and the company has been reviewed by your accountant.

In any stock purchase by your company, get sound legal and tax advice before moving ahead. In addition, remember this important legal fact: You, as a director and officer of the company, have a fiduciary obligation to all of your minority stockholders, irrespective of the number of shares they own. So be very careful. **tbo**

Cautions on Negotiating Business and Personal Contracts

Negotiations of legally binding contracts take place constantly in a business' operations. Protect yourself in all contract discussions, whether business or personal. You don't want to lock yourself into a deal before your advisers have reviewed it.

If your talks take place in a series of emails, as is often the case, be careful. You may unknowingly be entering into a binding contract when you sign a letter or send an email outlining the terms of a proposed deal. To avoid this occurrence, and to maintain your credibility if you have to change the deal, consider ending all negotiating correspondence with a sentence like this:

I will, of course, consult with my attorney before any agreement is finalized, and the matter is subject to my attorney's and board of directors' approval.

If you can't agree to a request, explain why and try to offer something in exchange. Good deals are built on a series of concessions and compromises. Finally, be sure to get sound advice when negotiating any major contract. That way, all the business, tax and legal considerations can be thought out well in advance. [tbo](#)



"There's a lot of fine print; let me get my reading coals."

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Negotiating Checklist

Here is a list of items you should make sure are covered in any contract. Being familiar with them will also help you during your negotiations.

- Identify the parties and the purpose for entering into the contract. This is critical to establishing the overall reason for the purchase and sale.
- Delineate precisely the price, terms, delivery requirements, payment schedule, cancellation provisions and penalties for noncompliance.
- List all warranties and representations (e.g., accuracy of the financial statements), and specify the conditions to be met prior to closing.
- Be sure the contract is self-contained, meaning that it excludes all items not written into the contract, such as prior memoranda. If prior memoranda prepared by the other side are very important, your lawyer should include them as addenda to the contract. This also applies to any information you rely on and the accuracy you want the other side to attest to.
- Provide for instances of default and a specific time period to correct the default.
- Secure the right to assign the contract because it may be very important when negotiating and closing a future transaction. An example might be a real estate lease. You will want the right to assign the lease to another party if you need to relocate prior to expiration of the lease term.
- If you're a buyer, check all liens, tax claims, employment contracts, legal disputes, warranty liabilities, unfunded pension costs and any other contingent or off-balance-sheet liabilities.

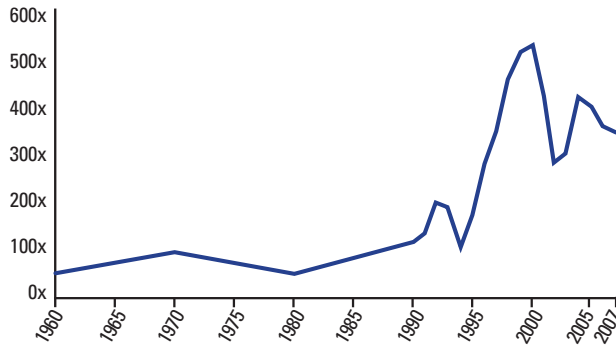
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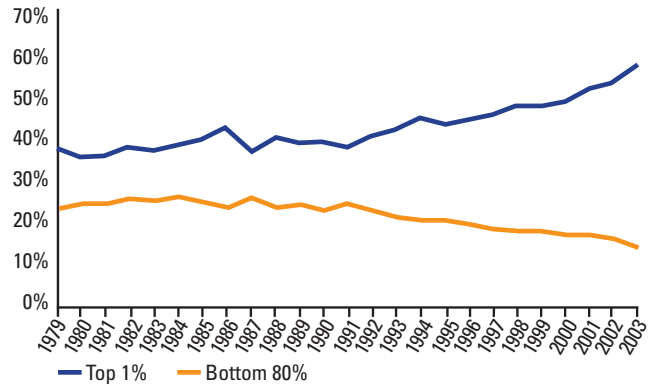
STATISTICAL DATA OF INTEREST

CEOs' Pay as a Multiple of the Average Worker's Pay, 1960–2007



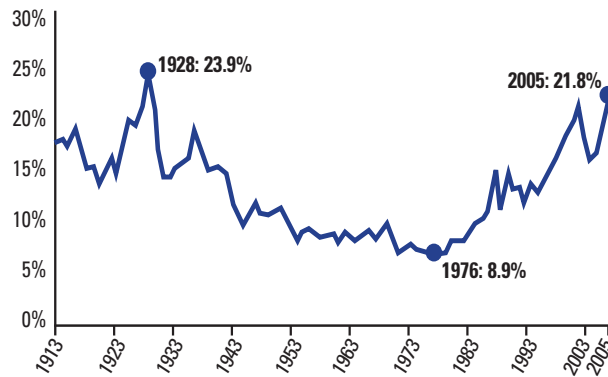
Source: *Executive Excess 2008*, the 15th Annual CEO Compensation Survey from the Institute for Policy Studies and United for a Fair Economy.

Share of Capital Income Earned by Top 1% and Bottom 80%, 1979–2003



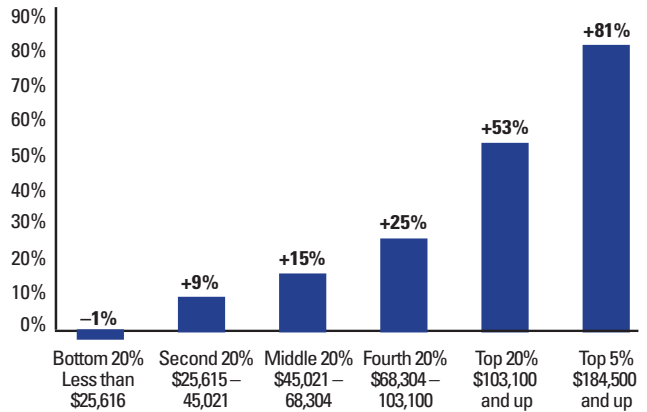
Source: Shapiro & Friedman, 2006

Top 1% Share of Total Pretax Income, 1913–2005



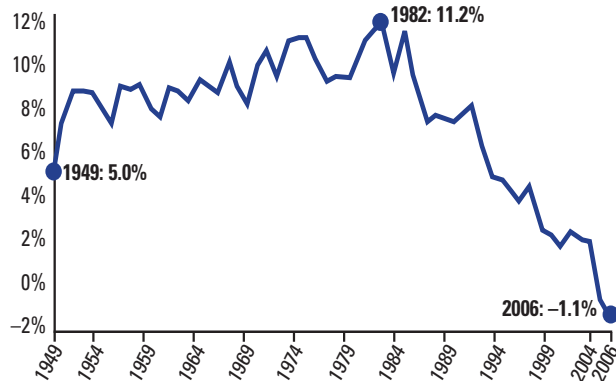
Source: Thomas Piketty and Emmanuel Saez, "Income Inequality in the United States, 1913–1998," *Quarterly Journal of Economics*, 118 (1), 2003. Updated to 2005 at <http://emlab.berkeley.edu/users/saez>.

Change in Real Family Income by Quintile and Top 5%, 1979–2005



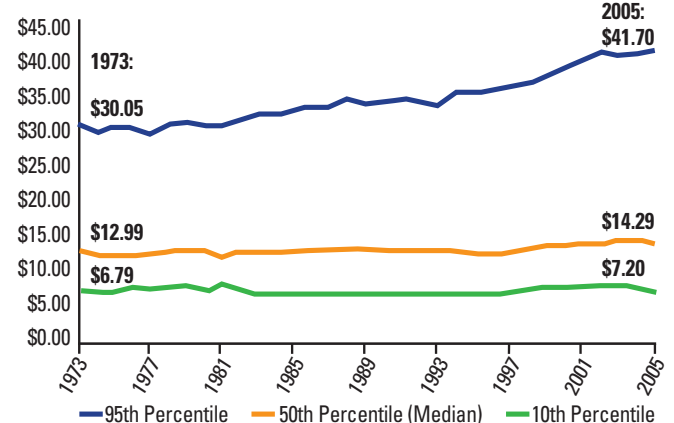
Source: U.S. Census Bureau, Historical Income Tables, Table F-3.

U.S. Personal Saving Rate, 1949–2006



Source: Bureau of Economic Analysis, National Income and Product Accounts, Table 2.1, Personal Income and Its Disposition.

Hourly Wages, 1973–2005 (in 2005 dollars)



Source: Economic Policy Institute, *The State of Working America 2006–07*, table 3.4.

RECENT BLOG POSTS

THEBUSINESSOWNER.COM/BLOG

Reflections on the State of the Union

January 31, 2011

Don't get me wrong — words are powerful. Can impact lives. Change the course of history. Even kill, literally.

Words give insight into the mind and heart of the speaker.

The words of some we take at face value. Others, they're just words.

We tend to respect people who speak little but take action. Let their actions and accomplishments do the talking.

Yes, the words spoken by President Obama provided some insight into what he plans to work on in the coming months and years. And I do think Obama has both great heart and mind. But, probably like you, State of the Union speeches leave me unsatisfied. Unsettled. For one thing, they hardly inform us about "the state of the union." It's more about politicking and positioning and inspiring.

Sure, we need to be inspired. We loved it when Reagan inspired us with his addresses. But today I guess we all just want to hear that the government will reduce spending, lower taxes, balance the budget and stop trying to solve all problems.

Obama appropriately touched on the key roles our federal government should play: security/defense, infrastructure development, maintaining the rule of law, education, fostering robust and fair trade, diplomacy, and — at times — supporting innovation. But we business owners know that one cannot continue to spend more than one brings in for sustained periods. What our government needs is to come to grips with the fact that the country is not nearly as rich as our elected officials seem to think. Our pockets are not nearly so deep. In fact, they are empty. [tbo](#)

Imagine: No Tax Experts Needed

February 15, 2011

Counting beans does not add to our gross domestic product. The money we pay to tax advisors doesn't do anything for our wealth or welfare. Ditto for the time we spend on tax code compliance.

How much more could we accomplish during a year if we did not have to mess with tax code compliance? Moreover, what would our economy be like if all the tax specialists were actually producing something that contributed positively to the free-market system and the economy? Even if they swept the streets, we'd at least enjoy the benefit of cleaner streets. Of course, one might surmise that most would choose more redeeming means for earning a living. Means more in line with their considerable intellectual capacities.

Our tax code is ridiculous. It can and should be simplified. Imagine if all taxes were collected at the retail counter. No year-end paperwork at all. Just pay an extra 20 percent on top of all goods purchased.

Or maybe it's no retail tax at all; everyone just calculates their monthly revenue and sends 1 percent to the city, 2 percent to the state and 7 percent to the federal government.

While we're searching for ways to make our country and workers more competitive in the global marketplace, maybe we should look here. [tbo](#)

LEGAL

Employee Called for Jury Duty

State laws govern your rights and obligations as an employer with respect to your employees' jury duty obligations. Every state requires you to allow your employees to fulfill their jury duty obligations. No state allows you to retaliate, demote, discipline or terminate employees for fulfilling their jury duty obligations, no matter how burdensome to the employer. Even if employees become obligated to serve for months on end, you must welcome them back when the trial ends — in the same position and compensation. Finally, very few states allow you to dock the employee's vacation or sick pay for days serving jury duty.

Few states require you to pay employees for time spent on jury duty, as if they were working for you. Tennessee is the only one that does.

Employers should craft their jury duty policies based on wage-and-hour laws of state(s) where they operate. In most states, exempt (salaried) employees who return to work for any part of a day in which they serve on jury duty must be paid as if they had worked the entire day. Also, night shift workers cannot be required to work on days they serve on jury duty. [tbo](#)

Mike Lissau contributed his expertise to this article. He is an employment law expert with Hall Estill. You can reach him at mlissau@hallestill.com.

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Excerpt from *The Quiet Exit*

Buyers don't care about you. Just your business.

If you want to sell your business for the best price and terms, get comfortable with the fact that the buyers won't really care about you or your business. Not that they're cold-hearted; they just haven't built the relationship. They don't have the history. They haven't shed the blood, sweat and tears that made it your baby. Made it a part of you.

So do yourself a favor — get comfortable with this fact before you sell it. The buyers are interested in one thing — making money. That's it.

Might the buyer be good for the business? Yes.

Might the buyer be good for the employees? Yes.

Can you choose your buyer based on, in part, his/her character, integrity and track record? Based on the likelihood he or she will invest in the established employee base? Yes. Yes.

But don't ask for more than is reasonable to expect in the area of "respect" or "understanding." When the day arrives that you are ready to sell, all you should expect — and work toward — is a fair price and terms — and possibly someone that you THINK has a good chance of succeeding. You can do your best to place the business in good hands, but you won't be able to guarantee it.

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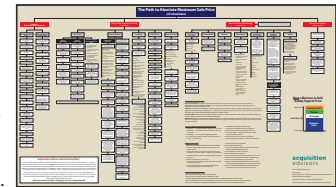
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Phase 3: Execute Sale Strategy — seven vital steps that must be performed properly

Phase 4: Post-Closing — what the seller must do after the sale

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