PacificCPE

COURSE
82605A

Navigating the Purchase of an Existing Business

Buying an existing business involves far more complexity than starting one from scratch. This course examines the key considerations involved in a business acquisition, helping tax and accounting professionals guide clients through due diligence, deal structuring, and the financial and tax implications of a purchase. If you work with clients who are exploring acquisitions as a growth strategy or entry point into business ownership, this course provides a strong foundation for those advisory conversations.

CREDIT HOURS 2 | FIELD OF STUDY BUSINESS | EXAM QUESTIONS 10

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LEARNING ASSIGNMENTS AND OBJECTIVES

Assignment

- Study the full course materials included here.
- Complete the review questions after each chapter.
- Answer 10 final exam questions.
- Final exam is scored immediately, 70% or better passes.
- Certificate of completion is available in your account.
- Failed exams can be retaken free of charge.

Course Objectives

- Identify the easiest business entity to purchase from a legal perspective.

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Chapter 1: BUYING A BUSINESS

Chapter Objective

After completing this chapter, you should be able to:

- Identify the easiest business entity to purchase from a legal perspective.

For those who would like to own their own business, buying an existing business might be a better approach than starting from scratch. After all, there's something attractive about letting someone else find a location and sign a lease; test the market and develop a customer base; buy furniture, fixtures, equipment, and inventory; hire employees; and perform the countless other chores that go with starting a business. In short, someone else will prove for you that the business works.

If you find yourself looking for an existing business to buy, keep an open mind. It's not always possible to buy a business you'll be happy with at a price you can afford. Many people who buy existing businesses do very well, but others, having explored the opportunities and finding nothing to their liking, return to the idea of starting their own business. And some people pay too much money for a poor business or one they might never really enjoy operating.

This chapter first looks at how to find a business to buy. Then it turns to the nuts and bolts of actually buying a business, including how to structure the purchase, what to investigate before closing the deal, and the legal documents needed for a business to change hands.

This chapter focuses on buying a business, but a seller's concerns are also discussed briefly under "Selling a Business," below.

FINDING A BUSINESS TO BUY

Before you look for a business to buy, narrow your field of possible choices. First, decide whether you want to be in a service, manufacturing, wholesale, retail, or food service business. Once you make this choice, consider the specific type of business you're interested in—perhaps a desktop publishing center, a management consulting business, a direct-mail processing business, a dance studio, a flower shop, or a used bookstore.

Your choice of business should be motivated by the type of work you've done in the past, courses you've taken, special skills you've developed through a hobby, or perhaps just a strong yearning to work in a particular field. It's almost always a mistake to consider buying a business you know little about, no matter how good it looks. For example, if you're confused by mechanical and electronic

equipment, buying an auto tune-up shop or a business that installs security systems makes little sense even if the business looks like a bargain.

If you're currently employed by a small business you like, what are the chances of that business becoming available to you? Maybe the current owner wants to retire, is in bad health, is moving out of the city, or is just getting bored. If you know the inner workings of the business and are sure that it's doing well—or at least that it has the potential to flower under your able leadership—that would be an ideal place to start. Failing that, perhaps business associates or friends could provide you with leads to similar businesses that could be available.

Here are some other time-tested ways to search for an available business:

- **Online marketplaces.** Business sale marketplaces, such as www.bizbuysell.com, www.businessesforsale.com, www.bizquest.com, and even www.craigslist.org, are a great starting point to find out what's out there for available businesses and to connect with sellers.
- **Professionals who advise small businesses.** Bankers, lawyers, accountants, insurance agents, and real estate brokers who regularly work with small businesses often know about available businesses before they go on the market. Think about who you know who is plugged into this network and get on the phone. A few well-placed phone calls might be enough to identify likely candidates in your area.
- **Business suppliers.** Another great way to tap into the grapevine is to contact the network of suppliers for that business. For example, if you're thinking of opening a flower shop, a floral wholesaler in your area will probably know who is thinking of retiring or selling out for other reasons.
- **Trade associations.** Almost every business has a local or regional trade association—for example, the Northern California Independent Booksellers Association or the Michigan Pest Management Association. An employee or associate of such a group might have heard about a business owner who's thinking of retiring.
- **The direct approach.** If you've admired a business from afar, simply drop in and politely ask if the owner has ever thought about selling. Who knows? Maybe that person has been thinking about moving to another part of the country or changing to a different type of business. Once in a while, you'll be in the right place at the right time. A long shot? Probably—but you have nothing to lose by trying it.
- **Business brokers.** Finally, there are business brokers—people who represent buyers and sellers of businesses, much as realtors represent buyers and sellers of homes. Most business brokers represent sellers, but others are buyers' brokers (also known as "buy-side" brokers). A seller hires a sell-side broker because the seller believes they'll get more for their business through a sell-side broker, even after paying the commission, than

they'd get on their own. You would hire a buy-side broker because you believe that you'll have more success finding a business to acquire, or, if you've already identified a target, helping you to close the deal and negotiate a better deal—better enough to justify the broker's fee. If you consider hiring a buy-side broker, do a thorough check on prospective brokers, including experience (general and industry-specific), references, and professional memberships.

WHAT'S THE STRUCTURE OF THE BUSINESS YOU WANT TO BUY?

If you find a business you're interested in, one important question is: What kind of legal entity owns the business—a sole proprietorship, partnership, corporation, or limited liability company?

Buying From a Sole Proprietor or Partnership

When you buy a business from a sole proprietor or a partnership, you acquire only its assets (and possibly its liabilities, depending on how the deal is structured), not the proprietorship or partnership as a separate legal entity.

Legally, it's simplest to buy a business from a sole proprietor, because one person owns the business and the assets are in that person's name. Buying from a partnership typically requires the consent of all partners before the business can be sold. If you're dealing with only one partner in a partnership, make sure that the person negotiating the deal has received proper authority from the other owners. Beyond that, get a clear understanding early on about whether you'll be buying only the assets of the business, or whether the seller is also trying to get you to assume responsibility for all liabilities. (Entity sales of a partnership are rare.)

Caution

It's best to avoid assuming business liabilities. You'll avoid many potential legal and debt entanglements if you insist on buying the business's assets only (even if this means a higher price). But whatever you and the seller decide, it's vital that you clearly record your understanding in the purchase documents.

Tip

Changing a business's structure. A new owner is free to change the legal form of a business. For example, you can buy a business from a sole proprietor and then operate it through a partnership or corporation.

Buying From a Corporation

When you buy a business owned by a corporation, you run into a special problem: figuring out the best way to structure your purchase. You can buy the corporate entity itself (the stock) or you can buy only its assets, leaving the seller still owning the corporation minus the assets you purchased.

In almost any purchase of a business, you'll be much better off buying the assets rather than the corporate stock. Buying assets has four distinct advantages:

- It helps you avoid the liabilities of the existing business.
- It gives you significant tax advantages.
- You can avoid acquiring unwanted assets from the corporation.
- You generally can get a higher tax basis for depreciable assets, which means there's less taxable gain to report if you later sell the assets.

Example

EXAMPLE OF STOCK PURCHASE: Brown Manufacturing, Inc., is a small corporation owned by Joseph Brown and his two sons. The company, which makes specialized computer circuit boards, owns a small factory, several machines, raw materials, an inventory of completed items, office furniture and equipment, and two delivery trucks. The corporation owns all of the assets of the business. In a stock purchase, you'd buy 100% of the corporation's stock from Joseph Brown and his sons. As the new owner, you'd elect yourself (and anyone else you choose) to the board of directors; the board would then typically appoint you to the office of president.

Get the Consent of Shareholders When You Purchase Corporate Assets

Remember that a corporation is a separate legal entity from its owners—the shareholders. When you purchase a small corporation's assets, you want to avoid the possibility of dealing with disgruntled minority owners. Even though the corporation's bylaws or shareholders' agreement might permit the corporation to sell its assets with the consent of the holders of a majority of the shares, it's far safer for you legally to insist that all shareholders agree to the asset sale. Get this consent in writing by:

- Requiring that all shareholders sign the purchase contract, and
- Asking that all of the corporation's shareholders and directors sign and give you a copy of an official corporate resolution authorizing the sale of assets.

A big bonus that comes with insisting that all shareholders sign the purchase contract is that they then become personally liable for the warranties and representations in the contract. Without their signatures, should things go wrong, your only recourse would be against the corporation, which by that time would probably be without funds. You can also include language committing each shareholder to any noncompetition clause in the agreement—but as with other noncompete covenants, you must pay the signer something to make the covenant legally binding.

Example

EXAMPLE OF ASSET PURCHASE: You want to buy the business operated by Brown Manufacturing, Inc., but instead of buying the corporate stock, the corporation sells you all or most of its assets, such as the factory, the machines, the trucks, several patents and trade secrets associated with circuit board assembly, and the trade name "Brown Manufacturing." The seller would continue to own the legal entity, Brown Manufacturing, Inc., minus its assets. You would use these assets to run the manufacturing business under the legal structure of your company (sole proprietorship, LLC, corporation, or partnership).

Corporate Liabilities

If you buy the stock of a corporation, you're buying not only its assets but any liabilities as well. This is fine if there aren't any liabilities, but this can be difficult to determine. Maybe the corporation owes federal income taxes that you don't know about or has a huge balance to pay on a bank loan. Or maybe a customer slipped in the entryway of the business three months ago, broke his leg, and is right now visiting a lawyer to prepare a million-dollar lawsuit. Or maybe an underground storage tank is quietly leaking into the earth below the corporation's main office. Hidden liabilities can surface for injuries caused by defective products, discrimination against employees, or environmental or safety violations, to name but a few.

In addition, the business might have contracts that you don't want to assume. For example, the corporation might have a five-year maintenance contract for service on the computers it owns and have four more years to go, at a rate you consider exorbitant.

You can protect yourself against unknown liabilities. A good investigation ("due diligence") into the business's finances should uncover many (though not necessarily all) potential liabilities. Get personal warranties from the seller, guaranteeing payment of any undisclosed or unknown liabilities that surface after the closing. Insurance can help cover some of these risks, such as claims for injuries caused by defective products. But recognize that buying the stock of a corporation can expose you to hidden corporate liabilities.

In contrast, by buying the assets of the corporation rather than the corporate stock, you can avoid virtually all of these liability problems as long as you don't lead creditors to believe that you're picking up the liabilities of the corporation.

It's important to realize, however, that under some circumstances, if you continue the business of the prior corporation, you or your new corporation might still be subject to some liabilities incurred by the old corporation even if you purchase only assets. Known in legal lingo as "successor liability," the most common area of concern is product liability—liability to a person injured by a defective product.

This situation is particularly likely to arise if you buy the assets of a corporation that manufactured a potentially hazardous consumer product and you directly continue the business. Each state has its own legal rules governing what constitutes a sufficient link (often called "continuity") between the first manufacturer and the second to hold the second liable. One court ruled that there might be such a link if:

- There is a continuation of the management, personnel, physical location, assets, and general business operations of the selling corporation
- The selling corporation quickly ceased its ordinary business operations and then liquidated and dissolved, and
- The purchasing company assumed the liabilities and obligations of the seller ordinarily necessary for continuing the business operations of the selling corporation.

In addition, depending on state law, a company that's just a continuation of an earlier corporation might be liable for other legal problems of the earlier corporation—for example, a wrongful discharge case brought by an ex-employee—or even for contractual obligations such as a union contract.

The good news is that if you're fully informed about the law in your state, you can usually anticipate any successor liability problems and structure your purchase to avoid them. Or you might be able to

buy insurance—often called "tail coverage"—to protect you from the long tail of the old corporation's liabilities.

Tax Advantages

You might be able to get several kinds of tax advantages in an asset purchase because you can allocate the purchase price among various assets you buy. As long as this allocation is based on an arm's-length negotiation between you and the seller, the IRS is likely to uphold it.

You want to allocate the greater portion of the purchase price to assets you can quickly write off or depreciate on your tax returns. These include things like the inventory of the business, supplies, machinery, equipment and vehicles, furniture, and fixtures.

On the other hand, you'll want to assign minimally reasonable values to assets that can't be deducted as current expenses, depreciated, or amortized. These include such assets as goodwill, trademarks, customer lists, and trade names. (How to allocate purchase price to different assets you're buying is discussed under "The Purchase Agreement," later.)

In addition, by buying assets rather than corporate stock, you can depreciate assets that the seller has already fully depreciated.

Example

Arthur is buying a dry cleaning business. The business has dry cleaning equipment that's 10 years old but in excellent condition. The owner has fully depreciated it. Arthur and the seller allocate $30,000 of the purchase price to the equipment. That way, Arthur can start to depreciate it a second time. If Arthur bought the corporate stock, he wouldn't be able to take any depreciation for this equipment.

Exceptions: When You Must or Should Purchase Stock

In some situations, you might not be able to swing a deal in which you buy only corporate assets. This can occur, for example, if the seller insists on a stock sale—perhaps believing there's a tax advantage in going this route. If you agree to this, see "Protect yourself if you buy corporate stock," below.

In some limited circumstances where the corporation has a uniquely valuable asset that can't be transferred, it could actually be better to buy the stock of the corporation rather than its assets. For example, the corporation might have tax benefits such as a net operating loss (NOL) carryover that you want to take advantage of. The NOL carryover would be lost if you purchased the assets rather than the corporate stock. Also, if a store had a favorable five-year lease with a five-year option to renew that isn't freely assignable, that can provide an incentive to you to buy the corporate stock. Or suppose a ski shop has a hard-to-get distributorship for a popular brand of skis. If the