

**HOW TO HIDE VALUE IN A FAMILY-
OWNED BUSINESS
... AND HOW TO FIND IT**

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How to Hide Value in a Family-Owned Business

...and How to Find it

Even a small business can be very complex

- Parent companies
- Multiple real estate holding companies
- Consulting company
- Shared employees
- Overhead expense allocations
- Dealership
 - four affiliates
 - transfer pricing issues with every affiliate
 - four real estate holding companies
 - family members in all companies

Why so much complexity ?

- Complexity doesn't mean something sneaky or illegal is going on.
- Legitimate reasons for complex structures
- Complexity to reduce taxes.
 - Legitimate reductions in federal, state, local
 - Improper reduction of taxable income.
- Business evolution over time creates complexity. Businesses start, stop, change.
- Multiple generations, multiple families
- Different aptitudes and desires to be involved.

Taxes create complexity

- Single biggest reason for creation of multiple entities.
- Personal expenses become corporate expenses.
 - For high tax bracket individuals, reduces net cost of the expense by almost 50%
 - Little likelihood of IRS attention if kept in check.
- Problem is, this distorts apparent value of the business
- Not just small businesses.
 - Local construction company building a house...
 - Auto dealerships = offshore income

Distortion of Value Driven by Divorce

- Flurry of activity
 - Movement of profits between corporations
 - Creation of new debts or guarantees
 - Increase in number of cash transactions
 - construction company
 - Real estate sales
 - Retirement account activity
 - Backdated contracts
 - Changes to ownership structure
 - Creation of minority interests
- Results in decline in apparent corporate profitability
- What about the CPA or corporate attorney?

What is the impact of complexity and subterfuge?

- Much more complicated to understand and establish value for a family-owned business.
- Reducing apparent corporate profits can have a huge impact on the apparent value of the company.
- A closely held company might be worth 4-6 X pre-tax income. Reduce profits by \$1,000 per month, and the apparent value of the business drops by \$50k to \$72k
- In other companies, the multiple may be 10X earnings. \$1k per month = \$120k reduction in business value.

Let's look at six ways that value can be hidden or distorted - in a closely held business.

- How it happens.
- How to find it.
- Not to teach you to be an accountant, but to review some techniques and vocabulary.
- Focus on questions to ask
 - Spouse
 - Company CPA or tax preparer
 - Company or personal attorney
 - Another accounting professional, like me.
- Following applies to C Corps, S, LLCs, all entities.

1. Put people who don't work on the payroll.

- Common cycle in family-owned businesses.
 - Salaries and bonuses to founding shareholders
 - With time, as founders retire, shares gifted to second generation
 - 1st generation salaries are scaled back as retirement arrives...
 - But not eliminated.. often smaller salary continues
 - But no work is done
- Gifts to grandpa become tax deductible
- Extend salaries to spouses, children
- Salary to new girlfriend, boyfriend
- Ill or semi-retired partners, or widows

1. Put people who don't work on the payroll. (cont)

- Recognition of past service
- Also provides access to benefits
 - Medical
 - 401k
 - Education
- Legitimizes perks like gas cards, company car, cell phones, travel.
- But what about the IRS...?

1. People who don't work....how to find them.

- W2s for statutory employees
- Examine last names and mailing addresses
- Identical W2 amounts
- Or amounts that reflect ownership
- W2 for the new girlfriend or boyfriend.
 - Changes
- Review multiple years of W2s
 - Changes
- Consider an organization chart
- Primary place of residence of a partner

1. People who don't work... how to find them. (cont)

- Evaluation of codes on W2.
- Look for pay that is not commensurate with duties

2. Payments to affiliates or related parties

- Temporary or long-term shifts of profits
 - From one company to another.
 - Or from company to a shareholder
- Perfectly legal, common
- Transfer pricing, such as selling to an affiliate
- Overhead expense allocation
- Often, management, consulting, advertising, or rent
- Administrative services, or for payroll administration.
- Licensing of patents, trade names
- Pay each other's bills, esp legal, accounting
- Create a huge opportunity to distort profitability of one entity

2. Payments to related parties

...How to find it.

- Comparative financial statements... last year vs. this year.
- Industry standards for profit margins
- Changes to intercompany contracts. Look at the most recent one.. and the last one.
- Evaluate changes to expense allocation. When last revised?
- Distortion because a partner is drawing a salary from only one company.
- Change, change, change... is the key to spotting.

3. Pay personal expenses through the company

- Everything from lawn and pool care
- ... to boats & airplanes
- Education expenses for dependents
- Legal and accounting
- Travel... Vegas to Rome
- Property taxes on personal real estate
- Personal car payment, for example..
- Hobbies
 - Boat and auto racing
 - Professional sports tickets
 - Contributions expense

3. Personal expenses... how to find it

- Check register
 - Data file, not on paper ctrl F... to find
- Expense account file
- Personal Property Taxes on personal return?
- Company financials for oddly high expenses
 - Benefits
 - Travel & entertainment
 - Advertising

4. Employee benefits

- Auto allowance.
 - Usually not proper for tax purposes
- Company car
 - Sometimes sold to owner for net book value.. or at a nominal price. Consider depreciation...
- Rent personal car to company.
- Gas card + one for spouse, kids.
- Travel
- Expense account for entertainment.
- Country club dues and charge account
- Interest free loans
- Cash surrender value of life insurance

4. Employee benefits... How to find it.

- Things to ask your client about:
 - Travel
 - Club memberships
 - Company credit card
 - Company gas card
 - Vehicle registration, insurance card
- Get detail of employee benefits, advertising, etc. on general ledger
- Statement of cash value on life insurance

5. Real estate

- Above or below market rents.
 - Years without changes... rightly and wrongly...
 - Recent changes to amounts in anticipation of divorce.
- Rent of unused or marginally used properties, such as home offices, vacation homes
- Sale of real estate
- Expensed leasehold improvements

5. Real estate... how to find it.

- Review current lease.. and the last one.
 - No changes, or recent changes.
 - Overpaying in a declining market
- Check county records ... search by name for recent sales
 - A certain Milwaukee business owner
- 1099 Misc for rent and misc. payments to non-corporations
 - Sometimes not issued but...
 - As always, look for changes

6. Depreciation

- It is the expensing of a long-term fixed asset
- Creates an asset that has reduced or no net book value
- Distortion between economic reality and tax accounting.
- Can significantly depress income and therefore the apparent value of the company.
- "Net book value" of assets (assets minus accumulated depreciation) may be meaningless
- Normal dep'n vs. bonus depreciation & Section 179 depreciation...economic stimulus
- Bonus depreciation does not apply to leaseholds but...

6. Depreciation.. What to do about it.

- Look at the tax return
- Look at detailed asset schedules... from CPA.
- Add much of recent Section 179 and bonus depreciation back into income.

Conclusion:

- 1099 Misc for rent and other payments to non-corporations
 - Sometimes not issued properly, or ignored.
- 1099 Int for interest
 - Where did the principal go?
- Use organization chart to understand players and evaluate W2 amounts.
- Create a chart and understand all payment flows.
- Oregon corporation division online
- Focus on documents that will be seen by the government, not on internal documents
- CPA knows only what they are told, and is often a captive of the relationship.
- Questions... time permitting.

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He now works as a consultant specializing in family-owned businesses.

Bill has a B.S. in International Business from Oregon State University and an M.B.A. from the University of Pittsburgh. He is a published author in such diverse magazines as The Bulletin of the Oregon State Bar Association, The Journal of Accountancy, Auto Dealer Monthly, Auto Rental News, and World at War Magazine. He speaks fluent Spanish and fair French, and he is restoring a WWII jeep in his spare time.
