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Advance Trade Discounts

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Introduction

From a business standpoint, keeping and maintaining safe and appropriate inventory levels is critical to the success of your business. Too much inventory means smaller cash reserves, while too little inventory could lead to possible lost sales. From a tax perspective, the value and treatment of inventory can mean paying more or less in taxes. Trade discounts, write downs, obsolete inventory, and specific inventory methods all have an effect on tax deductions allowable for inventory.

New Revenue Procedure

Recently, the Internal Revenue Service published a Revenue Procedure regarding advance trade discounts. A trade discount for practical purposes is a discount made to a buyer from a seller in exchange for the purchase of

merchandise. An advance trade discount is a trade discount where the discount is given to the buyer in advance of the purchase. Lately, a bit of confusion has resulted from the advanced payments. The IRS used to argue and take the position that the advanced payments were income, rather than a reduction in inventory cost. In the recent revenue procedure, the IRS has done an about face and has declared that advance trade discounts should reduce inventory value as opposed to being declared as income upon reception.

Definition

From the standpoint of the IRS, in order for a payment to qualify as an

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A CASE STUDY

The Tax Court disallowed a corporation from claiming \$2 million in depreciation deductions due to insufficient record keeping. The claimed expenses arose from the costs of purchasing, moving, and installing food - processing equipment. As evidence, the taxpayer provided a list of vendors, amounts recorded as moving expenses, and the testimony of a

lawyer familiar with some of the vendor's accounting practices. However, the taxpayer could not provide any invoices, purchase orders that stated the nature of the items purchased, or the dates of purchase. The Court found the evidence inadequate and unreliable. As a result, the claimed items were neither deductible nor depreciable.

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advance trade discount, the following items must be present:

- a payment from a seller of merchandise in exchange for a commitment by the buyer to purchase a minimum amount of merchandise within five years;
- the payment must be intended to be a discount to the original price of the merchandise sold to the buyer;
- the buyer must be obligated to repay an allocable portion of the monies received if the purchase commitment is not met; and
- the payment must not be for services rendered by the buyer.
- In order to use this method, the buyer must be an accrual basis taxpayer who maintains inventories and receives advance trade discounts in the normal course of business.

While at first this may not seem significant, this procedure has radically simplified accounting, reduced confusion, and also saves taxpayers a lot of money to boot in situations where advance trade discounts are used. Previous to this Revenue Procedure, there was some substantial confusion as to whether advance trade discounts were taxable income or merely a reduction in the cost of inventory. The difference lies in the timing of the payment of taxes. If the advance discount is considered income, taxes are due immediately. However, if the advanced discount is treated as a reduction of inventory cost, taxes are not due until the inventory is sold in the future.

Conclusion

The Center routinely prepares valuations, estate plans, tax planning, and many other business consultation services. If you are interested in the Advance Trade Discounts Method for your organization or any other service please contact The Center at once.



Dr. Bart A. Basi is an attorney, CPA, and the Senior Advisor of The Center for Financial, Legal & Tax Planning, Inc, a full service company specializing in financial, legal & tax matters. Basi is a nationally recognized author, lecturer, and advisor on how to structure deals to minimize taxes. Tax structure makes the difference between getting the deal done and watching the deal fall apart. Many of you may be familiar with Basi and the topics he covers in the Financial, Legal & Tax Advisory which may be read in various industry-specific trade publications.

A CASE STUDY CONTINUED:

Editor's Comment: This case demonstrates the importance of detailed and accurate record keeping. This holding is especially disconcerting because while there was evidence that expenditures were made by the corporation, the fact that it could not be determined when they were made kept the corporation from being able to deduct them, resulting in a greater tax liability. Many taxpayers with legitimate claims fail to substantiate them due to poor record keeping and as a result have incurred greater tax liabilities. Don't get caught with this problem, have a good accounting and record keeping system and keep it current.



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Points of Interest

- From a tax perspective, the value and treatment of inventory can mean paying more or less in taxes.
- A trade discount for practical purposes is a discount made to a buyer from a seller in exchange for the purchase of merchandise.
- Choosing the appropriate method of accounting for inventory can lead to tax savings in nearly any organization and lead to more appropriate financial accounting results.



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When It Is The Right Time To Sell Your Business, Will Your Business Be Ready?

Mike Ertel, CBI/ M&AMI/ CM&AA

It's been estimated that the owner of a typical small- to medium-sized business has up to 90% of their personal net worth tied to their business. Their retirement plan is simple: Sell the business for a whole lot of money and live off the proceeds. Problems can arise for a variety of reasons when the business owner is ready to retire and the business isn't ready to sell.

In many cases, the business owner has underestimated the amount of time it will take to prepare the business for sale, and/or the length of time it will take to conduct an effective marketing campaign to find the right buyer and negotiate the best price and terms and actually get the deal closed. In other cases, the owner is simply unaware of the steps he/she might take to maximize the attractiveness of the business, and ultimately its market value.

In the current economic climate, the buyers are also getting pickier and the successful seller may need to spend even more time and effort making their business saleable.

Experts suggest that business owners begin as much as 3 to 5 years – and in some cases longer – prior to their ideal “last day” in the business. While this might seem excessive, there are several good reasons for such a lengthy planning and preparation period. First, more sophisticated buyers will insist upon reviewing 3 – 5 years of historical financial statements, preferably reviewed or at least compiled by an outside accounting firm. Larger & more sophisticated buyers may require audited financial statements. If your business is not doing this now, it can obviously take several years to build up this well-documented financial history.

Furthermore, a business owner would be wise to anticipate some of the common issues that often show up in due diligence that will lead the buyer to either reduce their offer, or walk away from the deal altogether, and implement changes to eliminate or at least minimize them. Some common concerns are: Excess Customer Concentration; Lack of Management Deep; Threat of Technical Obsolescence, and Overdependence Upon the Seller

Additionally, a business owner might choose to implement several changes to improve the proven cash flow of his/her business, since this is so important in determining the ultimate market value of the business, and these can take time to implement and bear fruit.

Likewise, the owner of a small- to mid-sized business should allow about 1 year and in some cases substantially longer to conduct an effective marketing campaign to find the right buyer and negotiate the best price and terms, and actually get the deal closed. Finally, many savvy buyers will want the seller to stay on in a management/consulting role for six to twelve months, and in some cases much longer.

If you know of a business owner who's thinking of selling or buying a business and who might benefit from a free consultation with us, have them contact me, or any of the M&A professionals at www.bradwaygroup.com.

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Frequently Asked Questions...



Q: As part of my parent's business succession plan, I will inherit property. Will I have to pay taxes upon the receipt of the property?

A: Generally inheritances come to an individual tax free. It is the estate that must deal with the tax consequences in most cases. When an item is received by an heir, its basis is either determined by the fair market value upon the date of death or based upon the alternative date 6 months later.

Q: I have recently had my business valued. The value between what I believe the value should be and what is calculated are completely different. Why is this?

A: There could be any number of reasons for this dilemma. Valuations are based upon assumptions, figures provided, and calculations based upon them. The numbers, assumptions, and calculations may not necessarily reflect the value of the business to an owner. There are methods and procedures available to improve the value of a business to a willing buyer. It is with these improvements, a business' value can be augmented.

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