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Growing Your Business™

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Focusing on the opportunities of today's economy*

*connectedthinking

Success or failure in today's economy depends on your ability to manage challenges and maximize opportunities.

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As the mega-deals of the M&A world have slowed to a crawl, it's sometimes easy to overlook that the market for small- and medium-sized deals has substantially avoided the impact of the credit crunch felt around the world.

In a tale of two markets, medium-sized deals are where the action is

In today's economy, privately-held companies may be well positioned to take advantage of opportunities to buy or sell

Since most private company owners generally have the "Big Question"—what's my eventual exit strategy?—top of mind, this new era of stingier lenders and recalcitrant buyers is a good time to resurvey the landscape and reconsider options by asking: "If I want to acquire another company—or sell part of my own—what will be the market's reception?"

The short answer for sellers: Probably better than you think. Relative to the big deals, middle-market deals for strong companies are still getting completed, generally at reasonable prices. And for buyers, the news may be even better, because the still-difficult credit conditions may, in some instances, lead to more reasonable valuations.

A tale of two markets since the summer of 2007

Banks see the world differently today than they did prior to the August 2007 credit meltdown, and that dynamic has reshaped the deal-making forces at the high end. Not only is the volume of transactions down, but the value of those deals has dropped dramatically. The number of private equity deals greater than $1 billion peaked in the spring of 2007, and has been basically non-existent since then.

But for middle-market deals, a funny thing happened on the way to the credit crisis. Unlike the mega-deals that relied heavily on institutional investors to prime the pump, these middle-market transactions often involve bank debt, which—despite its generally higher price than in the pre-credit crunch days—is still readily available. The deal engine is still chugging along, then, for well-capitalized "strategic," or corporate, buyers that banks tend to favor in times of tight credit. For example, according to Thompson Financial, there were more than $6 billion in US mid-cap private equity deals in January 2008, double the $3 billion or so in September 2007 during the early stages of the credit crunch. The health of mid-market deals isn't just about the buyers, however. Mid-market targets typically have more transparent balance sheets compared to their mega-deal brethren, and there is less downside risk if the deal doesn't work out. And now that prices are presumably "post-peak," valuations could be more reasonable due to the lack of competition from private equity firms.

Tightened lending standards make for a tougher transaction

Still, deal-making isn't as straight-forward as it was during the past three or four years, when credit was readily accessible. Getting financing is the first hurdle. Bank loans are a crucial source of capital for privately-held companies, which face a more limited range of options for securing resources than public companies. Since deals are still largely driven by the amount of financing available, tightened lending standards means that both buyers and sellers face a much different landscape than this time last year.

Given the statistics, banks' queasiness is understandable. Many banks that had to write off subprime assets have since successfully built up capital, but spiking default rates in 2008 have prompted them to further tighten lending standards. After historically low default rates for 2006 and 2007, corporate defaults for the first five months of 2008 had already exceeded full year 2007 defaults. Around 28 defaults have been recorded globally, compared to 22 in 2007, and more than 100 companies are considered by ratings agency Standard & Poor's to be "close to the default threshold."[1]

Another factor contributing to banks' more conservative lending posture is that, for the past few years, banks were securitizing many different classes of loans, presumably spreading their lending risk among many different parties. The future market for many of these asset-backed securities is unclear, so the degree to which banks will be able to securitize future loans is cloudy, as well, leaving banks with more "skin in the game."

The more rigorous due diligence on the part of banks applies to both acquirer and target. Banks are most likely to lend to non-leveraged acquirers with strong balance sheets and the ability to supply a high percentage of equity into the deal. As for M&A targets, banks are paying more attention than ever to earnings quality. They now stress-test more aggressively how earnings would hold up during a slowdown in economic growth akin to the one we are currently witnessing in 2008.

Not surprisingly, increased scrutiny on the part of banks takes much more time. In fact, in some cases, it can take months to just find a lender. Additionally, as the amount of equity required to get a deal done increases, buyers are also being more cautious and measured in their diligence. The resulting slow down in transaction speed is a major adjustment between today's climate and the pre-credit crunch environment. Further, buyers are increasingly opting for a phased approach to the diligence process, allowing them time to "kick the tires" of the potential deal for a month or more, and then decide whether or not to go forward. On the deal side, private equity has to take a much more active role in the syndication process whereas before the banks would often self syndicate.

[1] "Corporate Defaults Reach 28, Exceeding Total for 2007," *Bloomberg News*, Bryan Keogh, May 2, 2008

The new calculus: bridging the gap between buyer and seller expectations

Both buyers and sellers should forget what kind of M&A experience colleagues, friends, or competitors had one year ago, or even six months ago. This is a new world, and hindsight regarding what other companies received for similar businesses in the previous credit cycle can make it hard to accept that the market has changed. "If you are a buyer, the capital market dynamics have changed and influence your approach," says Fentress Seagroves, head of the M&A practice at PricewaterhouseCoopers' Private Company Services practice. "If you're a seller, you can't get caught up in the price that a similar company went for a year ago or two years ago."

The changing nature of the landscape has induced considerable tension in the relationship between private company buyers and sellers. The constantly shifting sands under their feet only make negotiations more complex. For example, since the markets are changing so quickly, prospective buyers are often demanding "real-time" numbers from the target company right up until closing. Moreover, both buyers and sellers in this market must proceed knowing that credit markets could seize up once again, scuppering the deal.

Then there is the fact that in certain out-of-favor sectors, such as retail and financial services, prices have gone down so much as of May 2008 that many sellers have taken to the sidelines and are content to try and wait out the downturn, hoping that a healthier US economy in the second half of 2008 could improve their marketability.

What the buyer should keep in mind

For buyers, focused and rigorous due diligence, preferably with the help of a third-party provider, is critical. Saving a few dollars upfront won't look very smart if a company overpays for an acquisition in the end. A few key points to keep in mind:

- Bring M&A and due diligence advisors into the process early. It's best to know information about the target early on, rather than during the contract negotiations six months down the road.
- Expect more competition from foreign buyers, particularly from those in Asia and the Middle East as the weakness of the dollar has made US assets relatively cheap.
- Although it is tougher to get deals done in this market, historically, excellent investments have been made during economic and deal downturns.

What the seller should keep in mind

The first thing sellers should remember is that selling a company can be a full-time job, and someone has to run the business while the transaction is taking place. In the meantime:

- Look very closely at the lending sources that the bidders are counting on. Are they going to hold up in this difficult credit market?
- Be realistic about valuation; an unreasonable seller can introduce unneeded additional stress into the process and turn off potential purchasers.
- Prepare, prepare, prepare: Make sure you have performed your own financial, tax, IT, HR, and legal sell side due diligence prior to putting together and sending out your offering documents. Unexpected issues discovered by buyers can significantly erode value and seller credibility.
- Consider the ultimate objectives of the sale: It is not always about the money. It is more common than you think for a seller to choose a buyer who has offered less money if the seller believes it will be a better management fit, believes the buyer provides the greatest ability to close, or weighs other intangible items more heavily.

The mergers and acquisition deal flow for middle-market companies continues apace, despite the current economic environment. Although the timing and tenor of the transactions has changed, adaptable buyers and sellers of private companies are still finding attractive opportunities for growth in this market.

Want to know more about mergers and acquisitions for private companies? Please contact:

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China has replaced many manufacturing incentives with tax incentives focused on technology advancement, environmental protection, and certain major infrastructure development projects. US businesses with existing manufacturing operations in China, and companies conducting R&D or offering energy-saving equipment or services, should explore these tremendous new opportunities.

Policy changes and tax incentives signal new opportunities for US businesses

China's successful 30-year courtship of low-value-added "process manufacturing," or assembling goods in China for export, appears to be taking a new direction. China now wants to create a sustainable model of economic growth, ease trade tensions with major trade partners, and serve a growing domestic market. The changes to its tax and regulatory environment reflect these goals.

Under China's new Corporate Income Tax Law (effective since January 1, 2008), US businesses could benefit from reevaluating their existing operations and strategies and exploring new opportunities. "The new tax regime provides various types of very favorable incentives to US companies that possess the know-how for environmental protection and construction of major infrastructure and also offers the opportunity for US-based companies to expand their research and development activity in China," observes Alexander Pan, Partner, Private Company Services.

New tax regime supports priorities shift

The new China income tax law is all about economic development, with an emphasis in three key areas: technology advancement, infrastructure development, and increased environmental protection and product safety.

Under the old system, which included various export manufacturing incentives, China became the second-largest exporter in the world.[1] Per China's National Bureau of Statistics (NBS), in 2007 China's total exports reached $1.22 trillion.[2] This also helped China accumulate a foreign currency reserve balance of $1.53 trillion by the end of 2007.[3]

However, the export manufacturing program also presented additional challenges to China's economic development, especially on issues related to the deterioration of the environment, inefficient usage of energy and resources, and tension with China's major trade partners on trade imbalance. The new corporate income tax law is an effort to redirect the development of China's industry away from the low-value-added export manufacturing model and to provide stimuli for the development of China's technology-based industry. The new law raises the effective tax rate for foreign-owned manufacturing operations from an average of 15 percent to 25 percent. (Previously, many US-owned Chinese manufacturers enjoyed phased-in tax holiday incentives starting as low as 0 percent.) Also, many legacy manufacturing incentives were repealed and replaced with a wide spectrum of technology-based incentives.

[1] Source: World Trade Organization press release, April 17, 2008
[2] Source: Embassy of the People's Republic of China, January 12, 2008
[3] Source: Embassy of the People's Republic of China, January 11, 2008

In this new corporate tax environment, US businesses that manufacture in China may want to analyze their existing operations to see if they can be upgraded. For example, instead of continuing to run a back-end manufacturing process for shoes that can sell in the US for $20, the business might consider moving to China the design or research activity for the kinds of materials used in a facility selling shoes for $150.

If upgrading operations is not an option, US investors might consider relocating their factories where labor costs are lower, such as inland cities within China's central or western regions, or other worker-rich neighboring countries, such as Vietnam or Cambodia. "Based on China government statistics, in 2006, about 97 percent of the country's processing trade manufacturing operations were located on the coastal province," observes Pan. "And China still provides some type of incentive for those simple processing trades to move inland where they can continue to enjoy, at least for some time, lower labor costs and natural resources."

However, it is important to take into account that inland operations face additional cost and logistical challenges of moving goods from the factory to the harbors. Sensible planning requires seeking informed guidance. Historically, it has not been unusual to see local or county governments offer tax reductions and other incentives to foreign companies that set up operations and later are dismayed to find they are overruled by a higher level of government.

New opportunities in the China domestic market

While China's open domestic market offers the country an opportunity to control inflation and balance trade, US-based manufacturers could also benefit. These companies would do well to explore whether their product could be modified or adapted to what promises to be a lucrative market.

China still enjoys a robust economy and consumer spending has been picking up. Per its NBS, last year, China's GDP (gross domestic product) growth was 11.4 percent. According to the NBS, China's consumer spending in February 2008 in the retail segment went up 16.8 percent from the previous year for a total of $1.23 trillion; and the falling US dollar has meant increased buying power for US-made products.[4]

In January 2008, China's NBS revealed that last year, China foreign trade hit another historical high of $2.17 trillion, up 23.5 percent from the year before. That's a big boost on product import to China, where importation increased 20.8 percent from a total value of $955.8 billion US dollars. But perhaps the most tangible reminder of China's open market is the Chinese Government's new name for its largest, decade-old trade show. The "Canton Fair," which promoted primarily Chinese-made products to US buyers, is now the "China Import and Export Commodities Fair"—reflecting the government's effort to encourage foreign countries to sell products to China.

A wide range of technology and infrastructure incentives

In line with its new direction, the Chinese government is encouraging foreign-based companies to expand their research and development (R&D) activity in China. To qualified technology companies, China offers low tax rate incentives that reduce the statutory tax rate from 25 percent to 15 percent.

[4] Source: National Bureau of Statistics of China, January 24, 2008

The incentives also offer a 50 percent bonus deduction on qualified R&D expenditure, such as development of new technology, new products or new craftsmanship, or, if applicable, to allow an additional capitalization tax base on the intangibles developed. For example, if a Chinese enterprise incurred qualified R&D expenditure of $100, the bonus deduction enables the enterprise to add $50 and take the $150 deduction on its tax return. To qualify for the government-endorsed High-New Technology Enterprise status, an enterprise should possess its own core intellectual property rights and satisfy certain other criteria.

US suppliers that sell qualified equipment to China may also benefit indirectly from the new tax law, because their Chinese buyers may qualify to apply for up to a 40 percent shorter depreciation period for tax purposes. China buyers have more incentive than ever to replace technically obsolete equipment or other fixed assets that suffer from constant vibration or older equipment that has become severely corroded. And, buyers enjoy not only the typical infrastructure tax incentive, but also a 10 percent investment credit for acquisition of environmental protection, energy savings, or product safety equipment. For example, a China acquirer of technology equipment could use 10 percent of the purchase price to reduce, dollar for dollar, its China income tax liability.

US investors should be aware that local Chinese government officials have a very strong incentive to assist foreign-based technology providers in promoting energy efficiency products or devices in their jurisdictions. Two years ago, China's central government established energy savings standards that hold local government officials responsible for meeting an annual energy savings quota, and this outcome has become part of the officials' annual scorecards.

To accelerate the development of China infrastructure, the new tax law offers lucrative terms to developers who invest in certain qualified infrastructure projects. For example, a typical infrastructure tax incentive is the 3+3 incentive, or three years at 0 rate and three years at half the statutory rate, which would currently equal 12½ percent.

Income derived from government-endorsed infrastructure projects—as prescribed in the "Catalogue of Public Basic Infrastructure Projects"—may enjoy tax rate reduction incentives. These projects include:

- harbor
- wharf
- airport
- railway
- highway
- city public transportation
- electric power, and
- water resource utilization

Environmental hotspots: The new tax policy includes various tax incentives to Chinese enterprises that acquire technology or know-how on environmental protection, energy-saving-device manufacturing, or production-safety-

Protect your intellectual property rights

China's open domestic market, and its incentives to purchase technology and services from foreign-based businesses, could represent an enormous opportunity for many US businesses. However, it's important to take the proper proactive steps to protect intellectual property (IP) rights, rather than rely on local law. Steps a US-based technology company could take toward protecting its IP could include:

Sell equipment with the technology component made in the US, rather than attempt to make high tech equipment in China with a joint venture partner.

Add different layers of protection, depending on the type of technology and how it will be used. For example, if the technology includes both the hardware and software, be sure to manage software through licensing a customized version.

Combat piracy by retaining an upgraded software version and updating it periodically.

Use a good attorney to structure the contractual arrangements, add a penalty provision, and deter IP piracy with legal mechanisms.

Learning to protect IP by using a more secure business model, making appropriate contractual arrangements, and controlling how your business upgrades the technology, hardware or software, and management systems, is critical when approaching China's growing market for high-tech equipment.

processing design from foreign suppliers. Combined with China's increased energy-saving standards, this creates yet another opportunity for US-based companies that can leverage this know-how or technology. Such US businesses may wish to consider upgrading existing factories or introducing the technology or equipment to China's significant new factory market. China's many industrial parks also have the incentive under more stringent environmental standards to acquire wastewater service projects.

Income derived from the following government-endorsed environmental projects may enjoy 3+3 tax incentives:

- public sewage treatment
- public garbage treatment
- methane development and utilization
- energy-saving and emission reduction, and
- seawater desalination

China's open, prosperous domestic market, coupled with recent government tax and policy incentives, presents a new frontier for midsize US businesses leveraging technology or technological know-how. "If you are a US company, you would do well to evaluate whether your technology or know-how can be adapted or modified to fit with China customer needs," says Pan. "Small and midsize companies that face a saturated market in the US will find that the China market has a stronger incentive to buy its technology products, components, and services."

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International marketers remain ahead of their domestic-only peers

In PricewaterhouseCoopers' 1st Quarter 2008 Trendsetter Barometer Survey of privately held, fast-growth companies in the US, we found that companies doing business abroad outpace their domestic-only peers in both revenue growth and spending. Also, more international marketers are planning expansion into new markets, major capital investments and new strategic alliances.

	International marketers (n=100)	Domestic only peers (n=155)
Revenue growth rate	15.2%	9.8%
Plans to increase spending (net)	78%	62%
• New products/services	42%	30%
• Sales promotion	36%	26%
• Geographic expansion	26%	10%
• R&D	20%	10%
Planning expansion to new markets abroad	29%	1%
Planning major capital investments	41%	31%
Planning new strategic alliances	39%	29%

www.barometersurveys.com/trendsetter

With the tightening of the US economy and the need for state and local governments to increase employment and revenue, credit and incentive opportunities for companies continue to grow. Corporate site decision makers are increasingly aware that these incentives can make meaningful reductions to start-up and expansion costs and improve the overall return on an investment. Credits and incentives can be key strategic levers for companies as they consider how to execute their business plan most effectively.

Consider state and local business tax credits and other incentives in your site selection process

In recent years, state and local governments have created aggressive state and local tax credit and incentive programs designed to attract corporate investment. These incentives have the potential to be an important element in site selection decisions by improving the overall return on investment, but some companies miss out on their full value. How can you make tax credits and other incentives work for your site selection or expansion process?

A potential too big to ignore

Tax incentives typically eliminate or reduce taxes such as state income, local property, or state and local sales taxes, while non-tax programs generally come in the form of grants, rebates or discounts. Non-tax incentives can include investment grants, grants for employee recruitment and training and other job creation grants, low-interest and gap financing, infrastructure improvements, utility rate reductions and reimbursement of relocation costs, among others.

“Depending on the facts,” says John Flock, PricewaterhouseCoopers’ Chicago Credits and Incentives Practice, “these credits and incentives can have significant implications for a growing business in the form of lower tax rates, reduced start up costs for new locations, lower expansion costs, better access to local talent pools and improved overall return on investment.”

“And, there’s more on the table these days,” he points out. “State and local communities have become increasingly more innovative with their incentives in the hope of creating economic expansion and development.”

While many taxed-based programs continue to run strong, some states have begun to focus instead on other incentive programs. One recent development is the increasing number of “deal-closing” funds, which are offered when it appears that a project may be headed to an alternate location.

While some incentives, particularly certain tax credits, are automatic if a company meets all conditions and requirements, many of the potentially largest incentives are available only upon successful negotiation with the state or local community involved. And, after an incentive is obtained, a number of factors affect a company’s ability to use it. It is critical to take the right steps at the right time…and to avoid the wrong ones.

Do your homework right and do it early

"Companies often miss out," says Flock, "either because they don't know a program exists, how it works, or because they've waited too long to take advantage of it." Site selectors must identify available incentives early enough in the execution of both the site selection process and the overall strategic plan to secure and make meaningful comparisons and to manage the financial objectives—short, medium and long-term—of the company.

Michael Harris, Partner with PricewaterhouseCoopers' National Credits and Incentives Practice, points out the importance of identifying the full potential of available incentives. For example, he says, "Benchmarking data is available for many of these programs in terms of the number of jobs and amount of capital investment compared to actual provided incentives. Knowledge of actual deals can help companies get better offers."

Companies should be aware of the full range of possible incentives a state is in a position to offer before negotiations begin in order to allow for maximum negotiating advantage. In addition to the principal incentive, a state or locality may also agree to other assistance, such as help with training, recruiting or other employment matters.

One factor among many

While incentives can play a significant role in the site selection decision, the size of a potential incentive should be only one factor in the decision process. The site selection process is a complex one and it is important to consider many—and often competing—factors such as local labor market quality, cost and availability, utility and transportation costs, the existence of required infrastructure, building/site characteristics and overall tax burden. Says Harris, "A company should first consider all the business factors that make a site work or not, then add the tax incentives to the mix."

Some key considerations:

Start early It's never too early to identify available incentives when contemplating new or expanded facilities. Knowing what is available early in the site selection process allows you to optimize both opportunities and choices.

Be prepared You need to be prepared in order to take advantage of opportunities. Advisors can play a significant role in identifying opportunities, benchmarking data to provide leverage in negotiations and in dealing directly with state and local authorities.

Size isn't everything It is not the size of a potential incentive that counts; it is how much of it you will be able to use.

Smart negotiation and timing can make all the difference Be prepared. Don't show your cards early. Prepare the right message and allow enough time for the process.

Credits and incentives are only part of the equation The site selection process requires the consideration of many—and sometimes competing—factors. A company should first consider the business factors that do or do not make a site work, and then factor in potential incentives.

Credits sometimes play a role in mergers and acquisitions In some situations, credits can be transferred in merger and acquisition situations but opportunities are often overlooked.

Take advantage of missed opportunities In certain circumstances, missed tax credit opportunities can be obtained through later refund claims.

Careful timing and careful communications are key

For negotiated incentives, it is essential to have leverage in the negotiation process. "Leverage exists only when you legitimately have multiple locations under consideration," Flock notes. "If a community concludes that a decision has already been made, there's no point for them to provide the incentive. A premature press release or other public announcement can kill a deal. And unfortunately we see that quite often."

It is not only public announcements that you need to handle with care. Once you develop your short list of locations, your site selection team will go on site tours, perhaps accompanied by a representative from the state or local government. "Keep your preferences close to your vest," says Harris. "If you talk about how inexpensive a site is or what a great fit it is, your negotiating leverage may be all but gone."

Flock adds, "It's also important to remember that communities need a certain amount of lead time for reviewing and approving incentive applications. Many companies miss out because they haven't allowed enough time for the approval process."

Bigger isn't always better, and other pitfalls

Once offers start coming, "Don't let your eyes get big," says Harris. "When evaluating competing incentives, look at whether you will actually be able to utilize them. This is one of the most frequent errors in evaluating incentives. For example, if a company forecasts a net operating loss in the state of question, it may be better off accepting a grant of land valued at $1 million than a state tax credit theoretically worth much more."

"In one case," he continues, "a company negotiated a multi-million dollar incentive on their own, but failed to consider how effectively they could utilize it. Three years into the program, the company had only used $100K."

"At the end of the day," says Harris, "if you can't use an incentive, it's not worth anything."

Capitalizing on your negotiated incentives:

Take advantage of refundable state tax credits The ability to use nonrefundable credits depends on the presence of taxable income, while many start-up facilities take years before they generate taxable income. Be aware of opportunities for refundable credits instead.

Determine if nonrefundable credits may be monetized in certain circumstances Some states allow certain tax credits to be used against other tax liabilities; others allow taxpayers to sell certain nonrefundable credits.

Pay close attention to written agreements Review all agreements carefully to be sure they contain provisions that will allow the company to capitalize fully on offered credits.

Don't run afoul of "but for" provisions Many state incentives require compliance with "but for" criteria, i.e., the presumption that a company would not have relocated without the incentive. In many cases, if contracts have already been put in place, i.e., land acquired, it may be difficult for a company to explain that other options are still being considered.

Savings in action—four examples

The CEO and partial owner of a business wanted to add a new plant. After narrowing the number of potential sites to three through its realtor, the company asked PricewaterhouseCoopers to assist with the incentives aspect. The three communities were generally on equal footing until incentive offers arrived. One site offered $16 million in incentives, of which $5 million would be recognized in the first two years, offsetting a significant portion of start up costs. The other community offers came in at $6 and $10 million respectively, with less upfront cost offsets. The value of incentives related to the project was the final determining factor in making a selection.

A privately owned company was seeking to expand its manufacturing operations in the South. The company had approximately $200 million in sales at the time and was looking to add 400 new manufacturing jobs with an average wage of $10 per hour. After they narrowed down possible sites to three states, they contacted officials in each state to negotiate an incentive package. Of the three, the highest offer was $1.5 million. The company's facts were benchmarked against other deals to determine whether the offer was in line with incentives provided to other companies. Based on that data, the company renegotiated and increased the offer to more than $10 million.

A company was considering a strategic decision to move call center operations to India in order to take advantage of significant labor cost savings. After informing local state officials of the intended move and requesting an offer to persuade the company to stay, the state and local governments provided the company an incentive package worth more than $14 million, which offset enough of the labor costs to convince the company to retain the call center in the US.

A privately owned automotive supply manufacturer doing business in a single state was considering moving operations to Mexico for cost savings. The state offered the company $1.5 million of incentives based on the retention of 200 employees and 50 new jobs. Absent these incentives, the company would not have stayed in the US and would have been forced to deal with a move to Mexico.

Another pitfall in negotiating is being overly optimistic about projections. "When incentives are based on projected investments or new jobs," says Flock, "we caution clients to be realistic in their projections, because it is easy to be tempted to over commit in order to push the incentive needle up." It is important to be aware that most incentives have a "clawback" provision on the back end that can require recapture if targeted levels of jobs, wages, or capital investment are not met.

It is also essential for company site-selection executives and company legal counsel to review written incentive agreements closely to make sure there are specific provisions allowing the company to capitalize fully on the offered incentives.

Issues specific to tax credits

Tax credit incentives have unique considerations. For example, you will need to determine whether an offered incentive provides a true economic benefit to the company and when that benefit will be realized. Many start-up facilities take years before they generate taxable income and taxpayers that earn nonrefundable credits may receive no benefit from them for a number of years. For nonrefundable credits, you will also want to determine if they can be monetized in certain circumstances.

In order to optimize available credits, it is essential to accurately record and classify expenditures for qualifying assets, wages and other measures on which a credit is based.

It is important to note that some credits require precertification, though opportunities may exist to obtain retroactive certification. It is also sometimes possible to obtain credits on already-filed returns by looking at documents for qualifying expenditures, identifying missed credits and filing refund claims.

Mergers and acquisitions

"Opportunities are often missed in mergers or acquisitions," notes Flock. "In these situations, companies frequently consolidate redundant operations that may already exist with the buyer. A potential closure or cutback in activity can create commonly-missed incentive opportunities as jurisdictions scramble to retain high economic impact operations such as manufacturing."

In addition to non-tax incentives," he adds, "it may be possible to generate credits in a merger or acquisition situation based on acquired investment and/or jobs, or by transferring credits. But companies frequently miss these opportunities because they're caught up in the transaction itself."

Prepare an effective message

Flock advises: “When negotiating incentives, a company is typically in a much stronger position when it creates a well-constructed message for the state or locality. Potential incentive granters will want to know in detail about the structure of the company and the proposed project, how the proposed business fits into the local goal for targeted industries, the quality of any new expected jobs and perhaps even what sort of corporate citizen the company expects to be.”

A particular concern in this process for some private companies is disclosure. If you are seeking incentives, you can expect to be asked for financial statements and other information that you may not normally disclose. “You should know up front what to expect in order to avoid being blind-sighted late in the game,” says Flock. When a private company’s disclosure preferences are known up front, they can sometimes be addressed through special confidentiality arrangements.”

Don’t leave money on the table

One can anticipate that state and local governments will continue to offer and expand their economic development incentives to encourage businesses to locate and expand in their communities. Because these potentially substantial incentives can both reduce above-the-line operating costs and increase below-the-line tax benefits, they can be an essential consideration in the site selection process. Early and thorough action will allow you to make the most of these advantages.

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Complexities in tax regulations and greater system efficiencies of tax authorities can take a high toll on a personal wealth portfolio. Learn to live well while managing the tax consequences of owning multiple residences, airplanes, yachts or of other key decisions.

Understanding hidden costs in four key areas

What could be better than buying into a California vineyard in a burst of exuberance, moving to your new villa in Tuscany and becoming an Italian citizen, or renting your place in Maui to explore new destinations in your private plane or yacht? Not paying more than you must for living your best life.

As a high-net-worth individual, you have a world of possibilities to consider. Understanding how tax regulations and planning opportunities factor into your lifestyle choices can help you manage accumulated wealth effectively while enjoying it at the same time.

"Too often we see individuals who seek the necessary tax planning advice for their business decisions overlook this critical step in their personal spending decisions," observes Alfred Peguero, a Private Company Services partner. "With some advance planning, individuals can limit tax liabilities, take the appropriate tax benefits and revisit complex decisions as circumstances change."

Four planning areas to watch

If you are passionate about living your best life while preserving your wealth to share with others, it could help to address the tax ramifications in four key areas before making major decisions:

- the impact of multiple residences on your income and estate;
- the benefits vs. costs of an ownership stake in transportation, such as airplanes and yachts;
- the consequences of choosing the jurisdiction in which you keep your assets;
- the impulse to relinquish US citizenship.

The impact of multiple residences

Individuals seem to be making themselves at home in more locations than they did in previous generations. Instead of one vacation home at a favorite destination, some individuals today enjoy several homes in other states and countries. "With multiple homes across state and international borders come additional tax ramifications, planning opportunities and pitfalls to avoid," explains Karissa Lilley, Manager, Private Company Services. For example:

- **Renting out a home.** Before deciding to rent out the Maui home in which you spend just one-third of the year, you should be aware that this generates the need to file another state tax return. However, the federal tax code allows individuals to rent out their homes tax-free for up to 14 days, and

some states have versions of this law with varying time frames. That's good to know, especially if you have the opportunity to rent your vacation home located near future Olympic games, major golf or other sporting events.

- **Purchasing a home in a foreign country.** It can be tempting to purchase that $1 million villa while vacationing in another country. And, because you're not a citizen of that country and don't plan on renting the villa to others, there are no tax filings and no related debt filing. So, what's the issue? Your tax preparer needs to be aware of the little-known foreign trust beneficiary filing requirement with the US federal government. Failing to file the six-page Form 3520 in a timely manner carries a penalty of up to 35% of the property's fair market value. "Enforcement has become more strict since 9/11 and individuals who realize they unintentionally neglected to file such forms going back several years are working to settle the matter by filing previous years with the IRS," says Peguero.
- **Owning US property as a nonresident/non-citizen.** Non-US citizens living outside the US who own property in the US can become subject to US estate tax if they pass away with that property in their estate. There are various tax treaties with countries, such as Japan, that can mitigate tax consequences, but it is important to seek experienced local estate planners to help manage any US estate tax exposure. A time-tested technique for mitigating tax exposure with real estate could be to place it inside a US LLC owned by a foreign corporation, which is considered intangible and not taxable in the US.
- **Transferring home ownership to a beneficiary during your lifetime is especially desirable if you expect its value to appreciate significantly in the future.** Plan ahead and consider using tax-wise vehicles, such as a qualified personal residence trust (QPRT). A QPRT can be used to transfer a personal residence, either a principal residence or vacation home, to a beneficiary over time while continuing to use the residence. With a QPRT, you can pass the asset onto the next generation at a discounted value over 10 or 15 years and not be taxed on future appreciation. It is treated as a taxable gift today based on the calculated present value of the residence at the end of the term of the trust. Gifts to these trusts are less attractive when interest rates are low because the gift tax cost is higher than it would be in higher interest rate periods.

  The asset transfers to the beneficiary at the end of the trust term, so to keep its current value out of your estate, you must outlive the term of the trust. When the asset does transfer to the beneficiary, you can either move out or pay the beneficiary rent, which is another way to move assets to the next generation outside of your estate.

Traveling in style

If you are considering the autonomy, convenience and security of owning a private plane be sure to seek qualified financial and legal advisors to help steer your planning. The ownership structure implemented for an aircraft can significantly affect federal and state income taxes, and excise taxes on fuel and transportation charges.

Since October 2004, a business owner who employs a corporate aircraft for personal use may deduct only the portion of costs that the individual includes as a fringe benefit in his income or reimburses—not all associated costs as allowed under the previous rules. A business-owned aircraft, either in whole or fractional part, is depreciated for regular tax purposes using five-year accelerated depreciation provided that it meets certain business-use tests.

An added layer of complexity in owning an airplane or yacht is that you're not just dealing with the IRS and local jurisdictions, but the FAA, TSA, US Coast Guard and, in some cases, foreign laws. For example, even though many sound business practices involve setting up a separate entity that businesses can rent or lease, this may not be appropriate for owning corporate aircraft. The FAA views an entity whose sole purpose is to own a plane that others pay to use as a business that should operate under a more restrictive charter license. If you're found illegally operating as a charter with only a general business license not only could you potentially find your insurance voided, but there could be significant fines and penalties.

Individuals associated with larger companies that must fly management team members domestically and abroad frequently, and with little notice, are primary candidates for owning a corporate aircraft. However, others might consider alternative arrangements, such as the following:

- **Fractional ownership.** A business takes title to a share of a plane but pays for another party to run the operations. This could be an option for companies flying 50 to 250 hours per year. Companies that need the flexibility for executives to fly out for time-sensitive deals, or sales teams traveling throughout the country that would otherwise pay commercial fares, often fall into this category.
- **Prepaid private jet cards or traditional charters.** In exchange for a one-time, upfront payment, prepaid cardholders are guaranteed a set number of flight hours of on-demand charter flight time. It is important to distinguish between prepaid flight hours on a specific fleet of known quality or traditional charter versus charter brokers for which little is known about the aircraft and crew. These options could be worth exploring for businesses flying 50 hours or fewer per year.

In addition, it is important to do the following:

- **Don't overlook state taxes.** Most states impose a tax on the sale and/or use of aircraft and, over the last few years, state revenue authorities have become more active in collecting these taxes. Multiple states may concurrently assert use-tax liability, claiming nexus based on a variety of activities related to the operation of the aircraft.
- **Keep appropriate records.** Identify individual travelers and the purpose of each trip to enable your business to prepare the reports required to obtain a deduction. Adequate records on each separate expenditure include detail on the amount of business use, the time and place of travel, business purpose and relationship of passengers to the owner. For aircraft specifically, records also include the miles flown, the number and names of passengers and whether the passengers were employees or guests of employees.
- **Consider the timing of any sale.** Try to time the disposition of your aircraft with the sale of other business assets that would have ordinary losses, or participate in a like-kind exchange. In light of related depreciation benefits, proper planning could help mitigate a potentially significant taxable event.

Though yachts do have the potential to be treated as a second home for tax purposes, they are less likely to be seen as a business expense. However, it could be possible for a publishing or public relations firm employee who entertains clients on a yacht to have this item reimbursed by the company and subject to a 50% deduction. In addition, the 100% owner of a company who is paying more than 50% of out-of-pocket costs for entertaining clients on a yacht might be able to take depreciation, or some portion of depreciation.

Protecting your assets

It can be appropriate to adopt advanced planning techniques to place assets beyond the reach of future potential creditors, such as consumers, clients or patients whose claims could exceed liability coverage. However, asset protection cannot be viewed as a technique to avoid or evade taxes or hide from known creditors or claims.

Just as there are varying levels of physical security you can layer on to protect the valuables you keep in your home, there are strategies for greater asset protection. Few tend to need the extreme of maintaining a Swiss bank account in an Isle of Jersey tax-free trust or a "tax-free" account in Tonga. It's true that these foreign jurisdictions do have asset protection type laws that help reduce an individual's exposure to creditor claims. However, such accounts are extremely expensive to maintain. They're not completely "tax-free"—as a US citizen you are taxed on your worldwide income. As a cost-effective alternative, consider going domestic. States such as Rhode Island, Utah, Missouri, Alaska, Delaware, Nevada, South Dakota, Oklahoma, Tennessee and Wyoming have asset protection language in their state laws and can get you close enough to the protection you need at reasonable rates—without any added risk of political instability.

Appreciating US citizenship

Thinking of leaving it all behind and relinquishing US Citizenship? The price could be higher than you think. A US citizen with more than $2 million of net assets and an average annual income of $124,000 for the five taxable years ending before the date of expatriation, automatically is deemed to be leaving the US for tax-motivated reasons. As a result, an expatriate is obligated to pay income taxes at his current rate for 10 years. Newer legislation seeks an expatriate exit tax based on the gain you would have seen had you sold all your gross assets. It's enough to make many reconsider such a move.

For today's high-net-worth individual, the financial picture has become much more complex in the past 20 years. Yesterday's 60/40 split of bonds and US stocks is today's portfolio of hedge fund, private equity, realty and offshore investments. And, the reporting requirements, greater system efficiencies of tax authorities and tax consequences of living your best life have kept pace. With the right advisors, you can afford to relax and enjoy your means knowing that you are managing it wisely, reducing your exposure and being tax smart.

Want to know more about managing the tax consequences of a high-net-worth lifestyle? Please contact:

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