LIQUIDITY EVENT LESSONS

WITH LATTICE WEALTH MANAGEMENT

[00:00:34.19] - Mike

Welcome to Liquidity Event Lessons. I'm Mike Ross.

[00:00:39.26] - Ryan

I'm Ryan Ross.

[00:00:41.23] - Mike

Liquidity Event Lessons are all about what you should be thinking about and doing both pre and post-sale of a business, certainly for the business, but really for yourself.

[00:00:56.08] - Ryan

In this episode, we speak with Nick Rosado of Kim Rosado Partners, which is a tax firm based in San Jose, California. They focus specifically on helping companies craft tax strategies with the IRS's rules in mind. These guys are both former IRS guys, and so they come at it from that perspective. Nick talks about tax strategies, best practices for selling a business, what things people are doing that they shouldn't be doing, and much more. So, enjoy this conversation with Nick Rosado. All right, Nick Rosado, thanks for coming on. Could you just give us a little bit of background about who you are and what you do?

[00:01:39.28] - Nick

Sure. I'm nick Rosado. I'm a tax attorney. I'm currently a partner with Kim and Rosado LOP. We're a small tax firm based in the Bay Area. We have offices in San Jose and Walnut Creek. But prior to that, both me and my partner were attorneys for the IRS Office of Chief Counsel. We would represent the IRS in court and advise IRS employees, revenue agents, revenue officers on legal aspects of the cases that they were building. In particular, I was a fraud coordinator for the San Francisco field office of the IRS Office of Chief Counsel. I would advise field agents on all fraud investigations taking place in Northern California. There are always a lot of tricky legal issues when the IRS is trying to develop fraud cases. So that's something I did for about seven years before starting my own practice and going to business with my partner. And currently we advise clients on mostly tax controversy work. So, people who are usually already in trouble with the IRS, we help navigate that situation. We do advise clients before they get into trouble, ideally. And the things that can come up and how to avoid issues with the IRS.

[00:03:06.20] - Nick

We provide legal advice to people with difficult questions with tax law. And, you know.

[00:03:14.27] - Ryan

I feel like it is often that they come to you and say, If I were to tell you that I might have done this, but I haven't done it, but if I did, what would you say? Does that ever happen?

[00:03:29.16] - Nick

It definitely happens. I have to reassure people that, yes, everything you tell me is confidential and privileged. If you can tell anyone, you can tell me.

[00:03:39.10] - Ryan

I have a brother that did this. He's okay, right? All right. So, we just got an understanding of the scope of your practice. That has a question about who hires you and why should they hire you? Before we go into, I'm really curious, how did you guys go from working for the IRS? I don't want to say this is the opposite side because it's just offering this is what they're probably going to be asking you. Is that right? Or how did you guys identify that there was a need in the public sector versus the IRS? IRS is private sector, I guess. No, the opposite.

[00:04:21.04] - Nick

Yeah. It is definitely the opposite side. We're across. When we're in court, we're on the other table. The IRS attorneys now are, they're opposite of it. So, it's certainly what we're doing is opposite, but it's all part of the same system. And we're actually assisting in helping people to be compliant and to avoid those issues. So, in a sense, it's the opposite, but it's also it's all part of the same system.

[00:04:51.02] - Ryan

Well, yeah. Now you guys understand the system. So, you can say, this is what you need to know in order to be compliant.

[00:04:59.07] - Nick

That's right. And then that saves everyone a lot of trouble in work. But I guess how we came to it was we were on the government side for a long time, and we would come across practitioners representing taxpayers that maybe we didn't think they were doing such a great job. So, we thought that there was opportunity in the private sector if we were to open up our own firm and be able to provide, I think, more inside knowledge that we had gained and how the procedures and everything was in place. Most people, if they haven't worked there, don't know exactly all those procedures and how everything interacts. And so, I think we thought we could give a better, just a higher quality service if we were to come outside. And so, we took the plunge.

[00:05:56.17] - Mike

So, Nick, in that answer, in that description, you hit multiple questions that I'm going to ask you, but let me start with maybe the easiest, which you've covered a little bit. When do people typically hire you? But more important, when should people hire you?

[00:06:16.22] - Nick

Typically, when people hire us is when they're in pretty serious trouble. So when the IRS has initiated an audit, and I mean, that's even a good time to hire. Once you get the initial audit letter, that's great. But usually, it's when things have gone sideways, when the IRS is proposing huge adjustments, maybe when things have ratcheted up and it's looking like there may be more serious issues other than just some simple dollar, some dollars that are owed. So usually, it's that situation. Sometimes people have huge balances that they owe to the IRS or to the state agencies, and they want to correct it at that point. So that's most often where we come in. When should we come in? Ideally, what I like is helping people organize and get the business set up and structured correctly and get the right processes in place. So I think day one, when the business starts, that's certainly a good time to bring us in. Even if they're working with someone to set things up, maybe just for us to kick the tires and make sure everything looks good, because if everything is done right in the first place, there's never any issues down the road, right?

[00:07:43.28] - Mike

So, And is there a level in terms of earnings or sales or something in the case of a business where it becomes strategically good to do that and below that, it's just not worth the time and Is there a threshold there somewhere?

[00:08:03.06] - Nick

Yeah. I mean, it's just having a quick look at a business. It's probably worthwhile for anyone who's seriously going into business. So even if the business maybe isn't generating income up front, it's usually a good investment just to get everything in place because you never know where things will go. But I guess certainly for more in-depth issues, and certainly hiring an attorney is not an inexpensive proposition. So certainly, you want to more successful businesses. It'll be easier to eat some of those costs. But I don't think that, especially what we do, we're not a big firm, so I don't think that we're only looking at the bigger businesses. I think everyone could use at least a consultation and a conference just to discuss things.

[00:09:09.03] - Ryan

Regarding selling a business, the audience for this is going to be people that have recently sold, or maybe they're looking at selling their business, right? And with those clients in mind, do you ever find yourself in a situation where someone was going to sell the company and things went awry?

[00:09:28.21] - Nick

Well, I think, And I think moving back into some of the things I was just talking about, often selling the business, you've locked yourself into some of the tax results because you've already structured the business. The business is structured as tax aspects from day one, that once you're selling the business, that's going to lock you in. So, I think understanding in the beginning The life cycle of the business, what you want to do, and that's going to help you with the business structuring, because how the business is structured is going to have a big role in how you're going to be taxed at the end of the day. Because sometimes I've come across it. People think they're selling a business, they're going to pay capital gain. And sometimes, based on some of the aspects of the business and how maybe the buyer wants to structure the purchase. There may be ordinary income involved, which is tax at higher rates. And then there are a lot of issues with California, depending on how the business is structured and how the sale is structured with California taxes that might be higher than people would anticipate. So certainly, sometimes people get a number, and they think, yeah, this is great.

[00:10:59.11] - Nick

But again, we always, and I always tell people, you have to think about what's the after-tax number, right? It's not what's coming in, it's what you keep, right?

[00:11:11.05] - Mike

So reflecting upon this, my sense is that best practices is bring in someone with your expertise, if exclusive for a consult, two or three years prior to a sale, and just get either a thumbs up or a thumbs down in terms of the existing structure, number one, and then describe to them, really, the situation in terms of, Okay, I want this to be a capital gain and not ordinary income. Another one that I've come across just recently is someone anticipating selling a business and then moving from California to Texas. And you got to get the timing right and you got to get all the behavior right. So, my sense is best practices is work on this early and thoroughly and think through the next phase of your life before and spend a little spend a couple of bucks then so you don't have to spend bucks later. Is that a good way to appraise it?

[00:12:14.05] - Nick

Yeah, that's definitely a good way. So, if this is something, even if it's not imminent, if it's something down the road that you think, hey, at some point I'm going to want to exit, you have to start thinking about what that's going to look like. And the sooner you start, the better, right? Especially, I mean, if you're thinking about, hey, I don't want to be taxed by California, that's a very tight, dicey proposition. You have to start working on that well, well ahead of time. So Those are considerations that, yes, you have to start very early. And I think that's how I always approach things. If I think, hey, maybe there's a few different options. Let me see what those may... How they may play out, right? And let me do the research and figure out what option A, option B, option C might look like, even though I don't know exactly which way life is going to take me.

[00:13:12.22] - Ryan

Are there any things that people are seeing them do more in terms of structuring their business? Maybe it's the state that they're based in that they shouldn't be doing. Maybe it is the state or maybe it's just the way if it's an S Corp versus a C Corp versus LLC, or Can you point to anything that you are seeing like, Oh, you really shouldn't be doing that because of this. That definitely is going to lead to this bad situation. Anything stick out? Or maybe international businesses, right? I don't know if you guys deal with international, but maybe there's a high-profile thing that you can point to like, Oh, they should have done this differently.

[00:13:55.07] - Nick

Well, I mean, once you step out of the US and you structure anything out of the US, there's certainly just a lot that you have to be aware of. So, a lot of what we do is issues with international structures that people just weren't aware of reporting requirements for those international structures. So certainly, once you step foot out of the country, open up financial accounts, invest in mutual funds, organize businesses out of the country, you certainly have to pay attention. And that's always a huge, huge issue because the penalty is for not reporting international. You just have to report. So just not filing those forms and reporting these things can lead to just astronomical penalties. So that's certainly always a big issue. And I think that that's something that we deal with a lot, I think.

[00:15:05.25] - Ryan

Are there any specific industries that are more susceptible to these... I don't know if they're regulatory requirements, but are there any industries that are like, Oh, if it's banking, then you're going to want to make sure you definitely do this if you have an account in Bermuda, or if you're tech, it's a personal identification information issue, right? Like GDPR, you got to watch out for this. Are there any industries that have specific eccentricities, perhaps, that are unique to that industry Yeah, I think just, I guess, going back to the international aspects, some manufacturing companies will often set up subsidiaries overseas without maybe knowing about all the requirements.

[00:15:59.26] - Nick

In the Bay Area, certainly, technology companies will try to get intellectual property or other things like that overseas, and that has very specific requirements that you have to follow. So, yeah, I mean, it's with the IRS and income tax reporting, there's usually not industry specific things that you have to watch out for because the income tax is the income tax. But certainly, structuring is always an issue for every business.

[00:16:38.07] - Mike

So, in a scenario, I'm three years away. I know I'm going to sell the business. I'm going to sell it in two or three years. I may even have some buyers identified in that particular. And it's industry agnostic. In that particular circumstance, from a tax attorney's perspective is would you describe there to be any best practices or things to avoid in that scenario?

[00:17:05.09] - Nick

Well, yeah. I mean, so you just have to start. You have to look at what your business structure is, look at what the buyer is, especially if you have buyers identified. I guess, how do they want to structure things, right? So, I mean, certainly buyer wants to structure things as an asset purchase, usually while seller will want to structure things as a stock sale, depending on the circumstances, right? So, you have to look at your own tax aspects and say, Hey, maybe an asset sale is going to result in all capital gain anyway. So, for me, I'm agnostic on it doesn't matter which way it goes. So maybe the buyer is interested in doing an asset sale, but maybe the buyer does want to structure a stock sale. They want to continue the actual business, the business itself, and then maybe think about ways to structure a stock sale as an asset sale anyway so that the buyer can get stepped up basis on the assets as long as it doesn't affect you. As a seller, though, you have to think about, well, if I sell and if I structure it as an asset sale, is this going to result in capital gain or is there going to be some ordinary income because maybe I'm selling inventory and things like that?

[00:18:31.10] - Nick

Then you have to think about, maybe it's better for me to structure things as a stock sale, and how can I get there? Then do I ask, if we're going to do an asset sale and there are negative tax consequences for me, do I have to ask for more? Do I have to ask for them to bear some of that cost that I'm going to incur to sell the business because I'm not keeping as much money as I would want on the sale, right? So, yeah, looking at your tax aspects, looking at potential buyers and what they're going to want, and then trying to find a solution for both parties that's going to leave more money in everybody's pocket.

[00:19:23.19] - Mike

So, shift the circumstance, nick. Okay. The person did whatever they did. Perhaps they were thoughtful about it. Perhaps they were getting good advice. Perhaps not. Now the transaction has been done. It's done. Have you run into situations where folks have come in to see you and said, look, I did all this stuff. The transaction is done. And because of things around that transaction, they need to take action now to solve a problem or two. Is there a post transaction best practices, post-transactions, lessons learned that you've picked up over the years?

[00:20:04.04] - Nick

Yeah, so certainly it depends on the circumstances. So, I guess we can, probably the most egregious things that I've seen are large employees and large liquidity events receiving ISOs or stock options that they're recognizing that they're paying tax on. Even though they haven't received cash, they're receiving income based on the grant, but they don't have any cash in their pocket, and they, therefore, have a huge tax liability. They hold on to the stock and then it crashes. I've certainly come across it a lot where someone may have had millions on paper It's just the year prior, and now they have nothing other than a million dollar tax liability that they can't pay now. So that's certainly something that employees need to be careful of in these situations if they're receiving ISO. It's usually with ISOs because there are AMT issues there that people have to be careful with. So as an employee, you certainly have to be careful. And then as a business owner selling a business, not paying attention to tax aspects and maybe having large ordinary income and maybe even capital losses on the sale based on how things shake out, resulting in, yeah, I have a lot of ordinary income that I'm paying tax on, but I have capital losses that I can't use to offset it because maybe there are a lot of capital assets that have built in loss, and then there are ordinary aspects of the business, ordinary income aspects of the business that you're selling.

[00:22:11.22] - Nick

So maybe you think, oh, everything should net out, but maybe it doesn't, and you end up earning a lot of tax on a transaction as well.

[00:22:21.28] - Ryan

I have a question about advice. Have you ever run into a situation where the You brought in to consult on a business sale. Maybe some of the other players in the game are... They're just not offering good advice. From your perspective. A, have you ever run into that situation? And then B, what do you do in that case? How do you make sure that the outcome is beneficial to the client, but you don't want to burn bridges or anything. Have you been in that situation? And if so, how do you resolve it?

[00:23:09.17] - Nick

Yeah, we often have to burn bridges. We go in with bazookas. I mean, we look at things. If things are wrong, we're open about it. If we have to talk to other advisors and protect our clients' interests, we do it. I mean, it's something that we regularly do because people have messed up in the past. Now there's a bill that's going to have to be paid. Who's going to pay for it? Those are the uncomfortable conversations we often have to have in these cases. And certainly, we have to press our clients' interest. So, we just have to break things open and talk about it. I think maybe another thing to keep in mind with business sales is just due diligence. It's not only about, Hey, how much taxes are we going to pay? But has everything been done correctly? Often, we see this with S-corporations. There are a lot of things that will terminate an S-corporation. So maybe you think you're selling an S corporation, but then when someone comes in to buy it, they ask for all this information and they say, Oh, look, this thing was not an S-corporation. It was a C corporation the whole time.

[00:24:28.25] - Nick

And now you have a huge mess. So, I think doing the due diligence is very important and just being upfront. And that's how we operate.

[00:24:44.12] - Mike

Yeah. Oftentimes, my experience is that someone hires an accountant, financial adviser, or an attorney when they're 30, and they become your friend, your social contact, and now you're 50 or 60, and you want to sell it. And there's enormous peer pressure to keep those folks when in fact, you should really bring in some folks that are sharper and a little bit more up to date on things. Do you run into that also?

[00:25:18.15] - Nick

Yeah, you can see both sides of it, right? Because the person has been there for a long time. They know where all the body is. They know everything, right? So it sometimes brings someone in new, fresh. There's a lot they have to do to get up to speed, and certainly there's a lot of cost involved in bringing someone new. So, there's usually a lot of hesitation to bring someone new in. But in these circumstances, it's good to have just a fresh set of eyes to look at things and just to make sure. Because certainly, if that person has been there a long time, they've done everything. And if they've overlooked something or they just missed something, I mean, hopefully not, but they may be some interest in trying to sweep it under the rug or something. Whereas if you bring someone in fresh, they should look at it with new eyes. Right. Yeah.

[00:26:27.04] - Ryan

Makes a lot of sense. Well, cool. We've covered a lot of material in this, nick. I want to make sure people know how they can connect with you. And if there's anything else, you should be really asking your tax attorney just to make sure deals go smoothly and you're not caught. That’s the wrong word. Yeah, you don't find yourself in a bad situation.

[00:26:50.20] - Nick

Yeah. I think certainly having... I was discussing some of the due diligence. So, if you're thinking about a sale, just The tax aspect is great, but also the due diligence, making sure that everything is in place so that the business can be sold and that there are no liabilities lurking there for whoever purchases a business. And you don't end up in court five years later with someone saying, You sell me a bag of goods, right? So certainly, due diligence is important, and of course, somewhat taxable. So, the taxes are important and understanding what What's going to happen and how much am I going to keep? That's always an important question. So how to reach me? So our website, kimrosado.com Well, our contact information is there. My email, nick@kimrosado.com. Just feel free to reach out. So, if you're in this situation, if some of the things that we're talking about maybe raise some alarm bells or just makes you think that maybe this is worthwhile to discuss, feel free to reach out and I'm happy to talk to you.

[00:28:18.26] - Ryan

Wonderful, nick. Thanks so much for coming on the show, and hopefully, we can do one of these again in a little while.

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