Seller's Compensation: How Much, When, and Why

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Owners of printing and packaging companies draw salaries like everyone else. But, selling the business could mean changing the compensation structure in support of the deal.

For most people, salary is a straightforward concept: a sum of money earned as compensation for labor, typically obtained by direct deposit or paycheck every two weeks. This also is true for owners of printers and packaging businesses – until they sell their companies to new owners. Then, salary takes on dimensions that can influence both the terms of the deal and the financial outcome for the seller.

We'll look at three such situations: adjustment of salary to market rate; compensation for non-compete agreements; and payment made by the buyer to the seller as personal goodwill. The underlying assumption is that the seller will remain with the company in some capacity after the deal is complete. In our experience, owners who actively manage their businesses seldom walk away from their roles on the day of closing.

This is where salary adjustment to market rate comes into play. "Market rate" is the competitive amount of money that would be paid to someone other than the owner – a non-owning individual who doesn't get to specify what the amount will be, as the self-paying owner can. Some owners elect to pay themselves above or below market rate, and there is nothing wrong with either practice – the choice is a prerogative that every owner is entitled to.

But, at closing, financials have to be presented on a post-closing, stand-alone basis. This means that the selling owner's salary will be recorded as matching market rate, regardless of what the seller actually is being paid. If the amount differs from market rate, the buyer will make a pro-forma adjustment that reflects the seller's actual salary going forward for as long as he or she continues to work for the buyer.

If the seller insists on continuing to be paid over market rate, the buyer probably will want to take the excess amount, multiply it by the number of years that the seller is expected to stay on, and subtract that amount from the purchase price. For instance, if market rate for the seller's job were $250,000 per annum and the seller wanted to keep on receiving $450,000 for each of the additional two years he or she had agreed to remain with the company, the adjustment to the purchase price would be $400,000.

What the seller chiefly must think about are the tax consequences of the adjustment. Salary being what it is, the $400,000 will be taxed as personal income. But, if the seller's pay were scaled to market rate ($250,000 vs. $450,000), the $200,000 difference would be added back to pro-forma earnings – a more favorable calculation, in our opinion, for most sellers in these circumstances.

This is because the multiple of EBITDA in the deal (assuming that the sale is being made on this basis) applies to the add-back and thus to the overall value of the transaction. At six times EBITDA, the $200,000 difference adds $1.2 million to pro forma earnings, creating proceeds for the seller that likely would be taxed as capital gains at a lower rate than personal income. In many cases, this will be the strongest argument in favor of bringing the seller's salary to market rate before closing.

A seller's ongoing engagement with the company after closing is usually structured as employment at will: terminable for any legal reason at any time by the employer or the employee. This is another reason to reduce excess salary to a market level, because post-closing compensation is usually not guaranteed.

As a hedge against the seller's ending the relationship, the buyer may offer compensation in return for the seller's promise not to compete with the business afterwards. The amount specified in the agreement may be deducted from the purchase price.

Although non-compete agreements have been attracting increasing amounts of negative attention lately, they are commonplace, and they usually are a part of a sale transaction. Laws in most states uphold them as long as their scope is reasonable and the limits they impose are not excessively restrictive.

Buyers may also compensate sellers for personal goodwill: a non-tangible asset that the seller imparts to the business through personal expertise or the strength of business relationships. Including personal goodwill in the valuation of the company can have tax advantages for the seller – a point to explore in negotiations and due diligence.

Owners of successful printing and packaging businesses deserve to be rewarded for their efforts, both during their tenures of ownership and in their subsequent careers as employees of new owners. Keeping the salary fair and realistic from one stage to the next can be a delicate matter. Sellers should seek expert assistance in determining how much they have coming to them, and in what manner the payment is best made.

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