

ROD K. SUTHERLAND

Attorney at Law

OCEANA CENTER ONE
484 VIKING DRIVE
SUITE 120
VIRGINIA BEACH, VA 23452
PHONE: 757/468-7777
FAX: 757/468-7002
Website: rodsutherlandlaw.com

Email: RSutherland@rslaw.hrcoxmail.com

BUSINESS SUCCESSION SEMINAR OUTLINE

WHAT GOOD DID IT DO?

What good does it do to build a business if you never know how much is enough, what it will take to sell it, what it will take to keep it running after you retire, how it will provide your retirement, or even what it is worth right now while you are still in charge?

WHAT BUSINESS SUCCESSION PLANNING ACCOMPLISHES

The same way you built your business, you build your exit from the business

Consult your experts

Communicate your vision

Make the hard decisions, as you always have

Follow through on the plan

THE NEED FOR AN EXIT PLAN

At some point you *WILL* transfer your business ownership interest. Hopefully, it will be under favorable and voluntary circumstances, such as a transfer during your lifetime to your son or daughter, a co-owner, a key employee or a third party.

But the transfer may also be triggered by an unfavorable and involuntary event, such as death or disability.

It is vital that you begin planning now to cover both voluntary and involuntary transfers of your business interest. It cannot be emphasized enough the critical difference a moderate amount of planning will make to you - both in terms of creating a market and value for your business interest, and as a means of ensuring that you receive full payment for it.

Surveys of business owners report that the vast majority of owners wish to transfer the business to family, co-owners or key employees. Yet most owners end up transferring the business to outside third parties. The reasons for this are obvious: children, key employees and most owners do not have the money - and with no planning no money will be available to them. As a result, business owners have no option but to sell the business to an

outside third party.

Until you identify who gets the business when you leave it, the business succession plan cannot move forward.

There will be no one there to purchase your business interest until you carefully evaluate the advantages and disadvantages of transferring your business to each possible successor. Once that is done, the business planning process can continue.

By identifying your successor, you can assess what you want from your business and who can best give you what you want for the purchase of your business.

You have four options:

1. Transfer of ownership to your children by gift or sale
2. Sell your ownership interest in the business to other owners or employees. Especially with smaller businesses, a common retirement plan technique is to have a younger and active person or persons buy into your business while you are still active. Upon your retirement, the younger person(s) will purchase your remaining business interest
3. Sell your ownership interest in the business to a third party - this option becomes necessary because you failed to create a market for your ownership interest by sale to your family, co-owners or employees. This option often becomes a bargain sale for the buyer - and is the only alternative to liquidation; on the other hand a sale to a third party:
 - a. Results in cash to the owner

- b. Minimizes financial risk at your exit from the business
 - c. Eliminates family succession issues
 - d. Allows for a speedier exit from the business
 - e. **20% of businesses are for sale, but only one out of four actually sells**
 - f. May wish to contact a business broker or an investment banker
4. Liquidate your business - sell the assets, collect outstanding accounts, pay the bills, and keep what is left, if anything. This is a VERY BAD CHOICE if your business is a service business. Liquidation should be used only as a last resort. Don't even consider this

EXIT PLAN

- a. What is an exit plan that will allow you to leave your business the way you want and how do you create such a plan?
- b. There are many types of businesses and business owners, as a result, each business owner's exit plan will vary; yet almost all exit plans contain common elements.
- c. Discover how to minimize tax consequences to you, to the business and to the new owner upon transfer of your ownership.
- d. Discover how to structure the transaction to guarantee that you receive the monies due to you.

EXIT PLAN QUIZ FOR BUSINESS OWNERS

- a. Do you know your primary planning objectives in leaving the business, such as:
 - 1. Your departure date (retirement)?
 - 2. The income you need from the sale of your business to achieve financial security?

3. To whom do you want to leave your business?
4. Do you know how much your business is worth?
5. Do you know how to increase the value of your ownership interest through enhancing the most valuable asset of the company - the employees?
6. Do you know the best way to sell your business to a third party which maximizes your cash, minimizes your tax liability and reduces your risk?
7. Do you know how to transfer your business to family members, co-owners or employees while paying the least possible taxes and enjoying maximum financial security?
8. Have you implemented all necessary steps to insure that the business continues if you don't?
9. Have you provided for your family's security and continuity if you die or become incapacitated?

CREATING AND PRESERVING VALUE

- a. Most business owners are so dedicated to making money that they have little or no time to spend on creating and preserving value for their business
- b. Even so, it is time you find the time to begin work on your exit plan

EXCHANGING OWNERSHIP FOR MONEY

- a. Inevitably, every business owner will sooner or later leave the business
- b. Yet few owners think about that event as they build and run their businesses

- c. In no other event is the need for planning so obvious and the lack of planning so evident
- d. One of the following scenarios will occur:
 - 1. You will transfer ownership of the business during your lifetime because you want to retire. Without planning, you may well have to liquidate; but with planning, you will be able to sell the business to a third party, to key employees or co-owners, or to family members - all at minimal tax rates
 - 2. You will die or become disabled and the business will have to be liquidated unless business continuity arrangements have been planned and documented

MEETING PERSONAL AND FAMILY NEEDS

- a. You likely have no available market to which you can sell your business
- b. You need an exit plan should you unexpectedly die or become disabled
- c. Your business and family must continue even if you don't. Business continuity planning, estate planning and personal wealth accumulation, all reviewed annually, are critically important
- d. A business continuity plan provides the means for dovetailing ownership interests (such as death, retirement) and valuation and provisions for payment
- e. Without financial security and independence, you will never be able to leave your business
- f. Estate planning provides the mechanisms to continue the business and your family's lifestyle should you depart from the business unexpectedly

GOALS FOR BUSINESS OWNERS ONLY

- a. You have to decide how you want to leave your business and how that is to be achieved

- b. The rest of the planning process and all tax planning and implementation is dedicated to reaching the objectives you establish

INITIAL OWNER-BASED DEPARTURE OBJECTIVES CHECKLIST

a. Financial Exit Objectives

- 1. Leaving the business in style means, for me, having \$_____ of annual after-tax income for the rest of my (and my spouse's) lifetime

b. Personal Exit Objectives

- 1. I plan to work until _____
- 2. At that date I will no longer be an employee of the company, although I may want a large portion of my retirement income stream to come from the business

c. I Intend To Transfer The Business To:

- 1. The following child or children (Yes or No). If yes, who?

- 2. The following key employees (Yes or No). If yes, who?

- 3. My co-owners (Yes or No)

- 4. A third party, known or unknown (Yes or No)

5. I intend to pursue the following activities after I leave my business:

SUCCESSFUL BUSINESS PLANNING

- a. Use experts (CPA, Valuation Firm, Financial Advisor, Business Succession Attorney, etc.)
- b. Plan for the transition with your experts
- c. Anticipate taxes and how to pay them
- d. Plan your own retirement

VALUING YOUR BUSINESS TO MAXIMIZE WHAT YOU GET AND TO MINIMIZE WHAT THE IRS GETS

To exit your business, you need cash and the source of that cash is the business.

To determine the amount of cash you will receive, it is important to know the value of the business.

Two of your most important business objectives (your departure date and your financial security) are dependent on the amount of money you receive for your business.

If you intend to give the business to your children, the business must be valued and that value must be used for gift tax purposes.

For many business owners, the business constitutes the

majority of the owner's total wealth. The IRS knows this just as you do. Determining the value now allows you the opportunity to design an EXIT PLAN taking into consideration the goal of MINIMIZING the IRS's take.

If you, as a business owner, go through the valuation exercise well before the business is sold or transferred, you will be able to pinpoint the factors that are crucial to measuring and increasing (or decreasing) the worth of your business.

A well-designed key employee incentive compensation planning is central to increasing business value.

DETERMINING A VALUE FOR YOUR BUSINESS

Don't ask yourself "How much is my business worth?" The better question is "What is the most I can get for my business under the most favorable terms and conditions?"

There are a number of means by which to value your business:

1. Employ the valuation techniques performed by your CPA or a business appraiser.
2. Look to the marketplace. What would your business be worth to a third party?
3. Revenue Ruling 59-60 - this ruling issued in 1959 is still cited extensively today by the IRS and by business appraisers when placing a value on your business.

4. Additionally, the courts have, over the years, contributed their own ideas on how to determine a business' value.

So far, I have been a pretty good lawyer. I told you that your original question is not relevant, but that it can be answered in an infinite variety of ways and that there is no correct answer. I have told you that the IRS and the Courts have come up with many ways to value your business.

It is very important to determine your business' fair market value and its "going concern value" (goodwill).

GOING CONCERN VALUE VS. FAIR MARKET OF THE BUSINESS ASSETS

- a. If the business earning capacity is no greater than a reasonable yield or return on the fair market value of the assets, then there is no excess earnings capacity and no going concern value
- b. If the purchase price is based on the fair market value of the assets, then earnings on book value are multiplied by a percentage amount - typically the purchaser would want a return rate of between 15 and 20 percent
- c. On the other hand, if there are excess earnings, then there is a going concern value
- d. Purchasers are interested in the trend of earnings history, and they will inevitably give greater consideration to more current earnings of the business
- e. A typical purchase price range is 2 to 5 times the annual excess earnings capacity or going concern value

- f. One way of looking at this is to ask, "For how many years would a new buyer be willing to give you the excess earnings capacity of the business in order to purchase that earnings capacity from you?" - this analysis will also require a risk multiple as to whether the business can continue to earn excess dollar amounts
- g. The importance of your employees cannot be overstated: If you are unable to have in place a strong organizational structure that can exist and thrive independently of you, you may be able to only look to the adjusted book value of the business for valuation purposes
- h. This means you must do everything possible while you are still active in the business to ensure the permanency of that earnings capacity - which usually means finding, keeping and properly motivating key employees

CREATING VALUE IN YOUR BUSINESS THROUGH THE KEY EMPLOYEES

When you ask yourself, "What is the most effective way to create and build value in my business?", the correct answer is: "Finding, keeping and motivating key employees."

There are several important reasons:

1. Properly motivated by a profit-based incentive plan, key employees do increase the value of your business
2. Key employees often become potential purchasers/owners when you decide to retire or move on to another venture
3. If you decide to sell to a third party (or gift the business to your children), the continued existence of a stable, motivated management team will increase the purchase price

The future of your business is in large measure tied

into how securely the key employees are tied to your business. This is so whether you transfer your business to a child who is not quite ready to run the business, whether you sell to your key employees, or whether you sell the business to an outside party.

STOCK OR CASH BASED BONUS FOR KEY EMPLOYEES

Before learning how and why you should issue stock to key employees, you should also know why you should not do this.

Reasons NOT to issue stock to a key employee:

- a. In your case, perhaps a simple cash bonus plan based on the company's profitability would be a sufficient incentive for the employee to stay after you leave
- b. Make sure that, if you do issue stock to a key employee, there is a provision to buy back the stock from the employee in the event things turn sour
- c. If you do issue stock to a key employee, make sure there is a mechanism for fixing the value of the stock in the event you decide you want or need to buy back the stock from your employee
- d. A shareholder - even a minority shareholder - has substantial rights. Majority shareholders owe minority shareholders certain rights and obligations imposed by law
- e. Any shareholder has, by law, rights to access your company's books and records; the right to be informed about the financial condition of the company (including your salary and perks); and often a right to be consulted and given the opportunity to vote on major decisions of the company

Reasons TO ISSUE Stock to a Key Employee:

- a. It ties the key employee to the company by making him or her a part of the company
- b. The employee pays for the ownership, thus investing, quite literally, himself or herself into the company
- c. It provides strong incentive for the key employee to work towards increasing the value of the company and therefore increasing the key employee's benefit
- d. For this to work, the key employee will need a *meaningful* amount of stock

How to Transfer Stock to Key Employees

- a. A "non-qualified stock bonus" - the employee receives, at no cost, stock from the company. The fair market value of the stock is determined and the value of that stock is taxable to the employee as ordinary income in the year he or she receives it. The business receives an income tax deduction for the value of the stock bonus to the employee
- b. Allowing the employee to purchase the stock at either its fair market value or at a discounted price. If the stock is purchased at a discounted price (less than fair market value), the employee will have taxable income on the difference between the fair market value of the stock and the price actually paid, and the business will have an offsetting deduction
- c. A "restricted stock bonus plan" - stock is awarded to the employee in the first year of the plan and is tied to a (for example) 5 year vesting schedule. The employee has the option to elect to include the full value of the stock awarded to him or her as income and thus pay tax only on that amount (rather than later after the stock appreciates in value, resulting in a higher tax). If the employee leaves, the stock is re-purchased by the employer

- d. Performance incentives and a "golden handcuff" feature should be built into the plan so that stock is given only upon the attainment of defined performance goals
- e. The golden handcuff feature requires the employee to stay for many years to receive all the ownership you make available to him or her. There must also be a written agreement requiring the re-purchase of the stock upon the employee's termination of employment for any reason - this damage control instrument will obligate the employee to sell back using an agreed upon valuation formula

Stock Options:

- a. Two types: qualified and non-qualified. "Qualified options" is an incentive stock option and is a creature of the Tax Code. The qualified options price must be at least the fair market value at the date the option is first granted; the option cannot exceed 10 years and for no more than \$100,000 worth of stock per year; it is exercised when the employee pays money and receives stock in return
- b. Both types of stock options provide the key employee the right to purchase stock at a given price
- c. The primary tax difference between the two types of stock options are to be considered. Under today's tax rates, the qualified option is probably more attractive to your employees
- d. An incentive stock option plan can also be tied into a cash bonus plan in which the corporation gives the employee a bonus equal to the purchase price for the stock when the option is exercised
- e. As with the stock bonus plan, any stock option plan, whether qualified or non-qualified, should include a buy-back agreement (i.e., the "damage control instrument")
- f. Stock options offer more flexibility than does the stock bonus, and thus more planning opportunities for the owner and the key employee

- g. Stock options provide the added benefit of giving the key employee growth opportunities from the beginning without the need to pay money or even incur a current tax cost
- h. If you do not want your employee's exercised stock option to grant the employee voting rights (some degree of control of the company), then issue to the employee non-voting stock

There are Means by Which to Provide Deferred Cash Incentives that are More Attractive to Key Employees than Stock:

- a. The Cash Bonus Plan - the business owner simply promises to pay an amount of money, perhaps a flat amount or a percentage of the company's annual profits, if the key employee attains some measurable goal. It is simple and always welcome by the employee; however, it does not tie your top employees to the company
- b. "Qualified plan" benefits are income tax deductible when paid by the company and personal tax consequences are deferred until taken out which is terrific); but to be ruled "qualified", the benefit must reach all or most of the employees in the company on a nondiscriminatory basis, meaning the percentage of contribution must be the same for all employees as it is for you - which can become quite expensive; therefore, may want to consider vesting requirements (generally, no more than 6 years)
- c. The nonqualified deferred compensation plan - is the single best method of motivating and retaining your key employees. It is better to use an incentive based nonqualified deferred compensation plan. These plans do not have to comply with the burdensome and complex Internal Revenue Code and other regulations, but do not receive favored income tax treatment; or can provide benefits, such as medical insurance, disability income, life insurance, etc. which are tax deductible expenses while excluding those payments as taxable income to the employees

1. Is a promise to pay benefits in the future based on current or future past services of your key employees
2. As "nonqualified plans", they do not have to meet the formal funding, reporting discrimination and employee coverage requirements of "qualified plans" governed by the Employee Retirement Income Security Act (ERISA)
3. With the exception of sometimes having to withhold for FICA taxes, in certain situations, benefits awarded to an employee under a nonqualified deferred compensation plan are not taxable until the date when such benefits are actually paid to the employee
4. Partly because the corporation does not get a taxable deduction for any pre-funding of these plans, many plans remain unfunded and the benefits are paid out of current operating funds
5. There are methods available to accumulate a pool of funds that the employer may use to pay deferred compensation without subjecting the employee to current taxation (by use of informal funding methods)
6. There is an informal "funding" that is often necessary to avoid the pitfalls associated with not funding a nonqualified plan; the informal funding is set up by the business with the understanding and agreement that the funds must be accessible to the business's general creditors
7. If the funds are invested, they are usually invested in an asset that accumulates income without current income taxation, such as a life insurance policy or annuity. When this accumulation is paid out to the employee (or exiting owner), it is tax deductible to the company; thus giving the company a tax deduction on untaxed money

8. Best to credit a specific amount to a bookkeeping account on a regular basis
9. DO NOT use the defined benefit formula if you own a closely held company unless the company has the ability to fund the obligation
10. You may therefore decide to use an incentive compensation formula. The awarded benefits are credited to a special ledger account on the company's books and are paid to the employee at a future date - usually retirement age or a stated period of time (usually 15 to 20 years hence). If the performance standards are carefully selected, the business's liability to fund the plan exist only when the company can afford to do so
11. Vesting is the proverbial "golden handcuff" that provides motivation for the employees to stay with the company. Unlike qualified plans, there is no limit on the length of the vesting schedule
12. Often, it is best to combine a payment schedule with forfeiture provisions to make sure a recently departed key employee cannot use any accumulated money from the deferred compensation plan to compete with you. If the employee does compete with you, simply stop or do not begin the payments
13. Again, non-qualified deferred compensation plans for owners are seldom, if ever, "funded". Instead, they are a tool to move income earned by the business out to the owner after the owner's departure from the company

d. Phantom Stock Plans

1. Tied to the company's performance, the Phantom Stock Plan gives the key employees some of the benefits of stock ownership without requiring the employee to actually acquire stock ownership

2. Typically, phantom shares corresponding to shares of stock - but not representing any actual ownership - are allocated to the participating employees and credited on the business's books and records
3. The employee therefore has no shareholder rights
4. The employee's vested benefits are typically paid out at the time the employee terminates his employment with the company

e. Stock Appreciation Rights Plans

1. Are similar to Phantom Stock Plans, but the SAR units correspond only to the appreciation on a certain percentage of SAR units valued against the corporation's stock
2. The employee has no shareholder rights
3. The employee's vested benefits can be paid out in a lump sum or over several years
4. The employee benefits from the stock appreciation even though no stock was ever issued to the employee

You can also consider 401(k) plans and defined benefit plans.

LIKE OTHER NONQUALIFIED DEFERRED COMPENSATION PLANS, THE CHIEF ELEMENTS OF PHANTOM STOCK PLANS AND SAR PLANS ARE VESTING, FORFEITURE, PAYMENT SCHEDULES AND FUNDING DEVICES

IN SUMMARY, THE BASIC ELEMENTS OF A WELL-CRAFTED EMPLOYEE INCENTIVE PLAN ARE:

1. The potential benefits to the key employee are substantial enough to be meaningful
2. There are specific guidelines for the key employee as to how to obtain the objective or benefit

3. Attaining the key employee's incentive objectives also furthers the owner's goal of increasing the value of the company
4. The plan objectives are meaningful and realistic
5. The incentive plan "handcuffs" the key employee to the business
6. Covenant not to compete; covenant not to take other employees; trade secret covenant; forfeiture provisions
7. The benefits of the plan are communicated periodically to the key employees

Now is the time to sit down with your advisory team and take a hard look at your current employee benefit programs, especially those aimed at your key employees.

WHEN LESS IS MORE: GETTING THE MOST MONEY USING THE LOWEST VALUE OF YOUR BUSINESS

One important point: generally a sale of corporate assets (other than from an "S" corporation, partnership or Limited Liability Company) will involve double tax consequence to the seller. First, the "C" corporation will recognize gain on the sale of the assets (and pay taxes) and then the business owner will also recognize gain (and pay taxes) when he receives money from the corporation as a result of that sale.

Use of compensation agreements, deferred compensation, consulting or noncompete agreements can remove some of the pain from the double tax bite. Also, you can avoid a double taxation by sale of the stock of your business and not a sale of the assets of your business.

Have your CPA calculate the tax consequences of both a straight asset sale and those of a sale of assets and liquidation of the company.

Any tax "pass through" business (not a C corporation) will incur only a single tax on the sale of your business. This tax occurs not at the business level, but at the owner level. Accordingly pass through business entities are the

preferred form of doing business if you anticipate selling your business to an outside third party.

A "C" corporation can convert to an "S" corporation and then sell the business AFTER 10 years to remove the "built in gain" which existed at the date you converted the C corporation to an S corporation.

All this sounds confusing and complicated, and it is.

Simply realize you want a business entity that is not taxed as a C corporation. Using a tax "pass through" entity can provide a tax savings of between 15 and 35 percent of the purchase price!

Even if you do have a C corporation, there are still many ways to minimize or even avoid the double tax bite. It is almost always preferable to not be a C Corporation - assume your C Corporation has a net profit of \$50,000 at year's end. If you retain that profit in the corporation, the corporation pays \$7,500 in tax. If, instead, you pay yourself a bonus of \$50,000, the corporation has no taxable income because salaries are deductible. However, when you receive the bonus, you have another \$50,000 in taxable income and will pay approximately \$15,000 in tax.

On the other hand, if the corporation pays its net profit of \$50,000 to its qualified retirement plan, it gets a deduction, has no taxable income and therefore pays no tax. You defer the income tax until you receive your planning benefit.

- a. To exit your business, you want to convert this illiquid, unmarketable interests into cash - the more cash you receive, the better
- b. You will seek the highest possible value for your business ownership interest ONLY IF YOU ARE SELLING TO AN OUTSIDE THIRD PARTY
- c. If your objective is to gift the business to your children, valuation is absolutely necessary to determine gift taxation.
- d. Otherwise, you must make every effort to develop the lowest defensible value for your ownership if you wish to receive as much money as possible.

- e. If your objective is to sell the business to a key employee or employees, or to sell the business to your children or a co-owner, ask yourself, "Do these potential buyers have any money?" If not, from where are they going to get the money?
- f. Won't these people need to earn money from the business, pay income tax on it (TAX NUMBER ONE), then pay the balance to you to buy the business at which time you pay tax on the gain (TAX NUMBER TWO)? ***If the company earnings are distributed to the purchaser (such as a key employee), it will be taxed to the key employee as compensation-salary or bonus money. The key employee will then pay the after tax money to you (say, 65 cents on the original dollar of earnings and you, in turn, pay a capital gains tax on the 65 cents received, therefore a Federal and State tax of about 25 percent. The net is less than 50 cents on the dollar earned and paid out by the company.***
- g. *The higher the business value, the greater the purchase price; and the greater the purchase price, the greater the double tax bite*
- h. *It is vital that the cash earned and distributed by the company and given to you as you leave, be taxed as little as possible*
- i. ***The key is to get the income you want and need without subjecting the business cash flow - the golden goose - to the double tax.*** If the cash flow is subject to a single tax, there is more of the cash flow available to pay to you. You will not only receive more money, you will have a far greater likelihood of receiving it. The business will not need to earn as much money, or to allocate all of it to the buy out, thus increasing the chance of business survival.
- j. *The key is have you receive the money directly from the business and taxed once to you, have that money be deductible by the business (which means it cannot be for the purchase of your ownership interest), and then to sell the ownership interest*

*to the employee/purchaser for a nominal amount
(because that income stream is taxed twice)*

- k. USE OF DEFERRED COMPENSATION: (A non-qualified deferred compensation plan; perhaps have the purchasers - they must be employees - at least partially fund the deferred compensation plan before the buy out process begins; the employees must agree to have their compensation reduced prior to the buyout process; their compensation reduction will be used to pay to you in the form of deferred compensation benefits when you retire.) The business gets to deduct the deferred compensation payments to you. It needs one dollar to pay you one dollar. On the other hand, if the business is acquiring your stock, (a non-deductible capital acquisition), it must earn about \$1.60 to pay you your one dollar. For this type of plan to work, it must be in place well before you begin to sell or transfer the business (otherwise, the IRS might argue that the deferred compensation is payment for the sale of your stock).

- l. USE OF INCREASED RETIREMENT FUNDING: Contributions to retirement plans by the business are deductible, and the tax on income earned through the plan for your benefit is deferred until you withdraw the money from the plan. Ordinarily, these plans cannot discriminate in your favor as the owner; any funding for your benefit will also have to benefit the other participating employees. In companies where you and the purchasers of your stock are the only significant participants of your stock, it may be possible to have the purchasers (if they are highly compensated individuals) opt out of the retirement plan. At the same time, the funding formula can be increased so that a greater amount of the retirement plan benefits accumulate for you, but not for the other, and presumably younger, participants. You will then receive a disproportionate amount of the company's cash flow as a retirement plan contributions.

- m. USE OF AN ESOP: Used only with corporations who have a worth of at least \$10,000,000 and an ESOP worth at least \$5,000,000. It is a qualified plan, an Employee Stock Ownership Plan, usually profit-

sharing, adopted by an employer corporation which is designed to invest primarily in the employer's stock. There are many ways for the ESOP to acquire and finance that stock, each having different business and tax advantages.

- n. It is almost always best to hire a certified valuation specialist to establish an appropriate and defensible value
- o. By utilizing various planning techniques, you are able to receive the money directly from the business, on a tax-deductible basis to the company and ordinary income to you
- p. After you receive this money, you sell the business to the purchaser for one dollar

SUMMARY OF TRANSFER METHODS

As we have seen, a stock purchase is generally nondeductible to the buyer. The payment for the stock is ordinarily completely taxable to you after you have recovered your cost basis.

Deferred compensation is fully deductible by the business and fully taxable to you.

Retirement plan funding is fully deductible by the business and is tax deferred to you.

Thus, there is a sliding scale of income tax benefits. But like everything else in business, there is no free lunch. Any tax-advantaged transaction carries with it certain obligations and increased complexity that may cause you to prefer a simple stock sale.

SECURING THE BUYOUT OF YOUR INTEREST

The cardinal rule of all buyouts by co-owners, key employees or children is:

a. **BEFORE CONTROL IS TRANSFERRED, ALL OWNER OBJECTIVES MUST BE MET.** These owner objectives include:

1. Financial security and independence
2. Attainment of departure or retirement date
3. Business continuity
4. Other unique owner-based objectives, if any

Keep in mind that this class of purchaser does not have cash to pay to you, at least not in substantial amounts. The question then is: How can meaningful ownership transfer be accomplished?

For new owners to work long and hard you must dangle the carrots of ownership before them. But you cannot afford to give them meaningful control before you have attained your business exit objectives.

As a result, a natural tug-of-war pits you against the new owners. You are reluctant to give up control without receiving money, and the new owners are reluctant to make needed sacrifices and commitments without receiving meaningful ownership.

Avoid this obstacle by using a process which has worked for many of my clients:

- a. First, have the proposed new owners *replace you in the business operations*. The new owners need not know how to run the business as long as there are qualified key employees in place to help them operate the business
- b. Second, you as the owner, must *transfer the risk of financial loss to the proposed new ownership*. Usually this means you no longer personally guarantee debt, bonding or any obligation to the business such as leases, supply contracts and so on
- c. Third, *begin the ownership transfer process without losing control by doing one of the following*:
 1. Sell a minority interest in the business with the promise to sell the balance once your owner-based objectives are met, or the certainty of their being met is evident
 2. Begin transferring a majority of the equity ownership through non-voting stock or similar types of ownership interest while you maintain control by owning a majority of the voting interests
 3. Whenever transferring any type of ownership interest, always have in place a buy back agreement which allows you to reacquire all of the transferred ownership upon the occurrence of certain events, such as: default in making payments to you, default in making payments to third party lenders of the business, a decrease in the net equity of the business, or whatever measurements or standards you deem vital to the best interest of the business
- d. Fourth, when control is transferred, all owner-based objectives have ideally been met. But if not, financial security can be enhanced by any one or more of the following:
 1. Pre-funding your departure through enhancing retirement plan benefits to you
 2. Or establish a nonqualified deferred compensation plan for you. The purchasers

could at least partially fund your nonqualified deferred compensation plan before the buy out process begins. (They must be employees and must agree to have their compensation reduced prior to beginning of the buyout process. That compensation reduction will be paid to you in the form of deferred compensation benefits.)

3. Use an installment sale with substantial security in the form of ownership interests, the assets of the business, the personal guarantee of the purchaser and his or her spouse (to prevent transfers of assets from the defaulting spouse to the non-defaulting spouse)
4. Receive cash up front through third party financing. The owner is typically expected to carry back, in a subordinate position to the bank, the final portion of the purchase price - be sure the money you see up front is enough to accomplish your objectives as you might not ever see any more money
5. Receive cash via a partial sale to a third party. Finding a qualified purchaser of only a partial interest in a closely held business is usually impossible
6. Alternatively, don't transfer a controlling interest in the business, ever. Simply transfer enough of an ownership interest to entice and to attract the key employees (including your children?) as permanent co-owners. They will attain the controlling interest only upon your death through a pre-funded (with life insurance) buy-sell agreement. You will then receive the bulk of your "retirement income" necessary for financial security through ownership distributions from the business. These distributions will likely be in the form of partnership distributions or Subchapter S distributions or non-qualified compensation

AVOIDING ROADBLOCKS TO SUCCESS

- a. Periodic legal and fiscal reviews - "An ounce of prevention is worth a pound of cure" (Benjamin Franklin)
- b. Necessary to communicate with you advisors, allow your advisors to work together, to plan, to prevent problems from arising, and to resolve small problems before they become insurmountable
- c. A legal and fiscal review will have to be done prior to selling your business

MEETING PERSONAL AND FAMILY NEEDS

Can I eliminate taxes at the personal level? Yes you can. It is accomplished by use of a Charitable Remainder Trust. The proper use of a Charitable Remainder Trust can avoid or defer the capital gains tax. For example, transfer your and your spouse's business to the Charitable Remainder Trust. A valuation of the business will be done and the business will be sold for fair market value. There are no capital gains on the appreciated assets donated to the Charitable Remainder Trust and then sold by the trust since the recipient is the charity. You and your spouse get a current income tax charitable deduction for the portion that actually goes to the charity upon your and your spouse's deaths. The proceeds from the sale will be invested (thus diversifying your investments) and you and your spouse will receive annual income distributions from the Charitable Remainder Trust during your lifetimes. Upon

your death, the remaining funds will go to the charity you and your spouse designate. The amount that is gifted to the charity is excluded from one's estate for estate tax purposes.

If you are concerned about your children's inheritance, you could purchase a life insurance policy to replace your children's inheritance. If the policy is owned by an Irrevocable Life Insurance Trust, the proceeds would not be subject to any estate taxes.

By eliminating the "wastage" of capital gains taxes, the Charitable Remainder Trust allows you to use the sale proceeds from your business to provide an income stream to you. This means you either leave the business sooner or leave it with more income. Either way, you leave your business in style.

Transfer to Family Without Tax

Use Grantor Retained Annuity Trust, an Intentionally Defective Grantor Trust, a Family Limited Liability Partnership or a Family Limited Liability Company

BEFORE THE SALE OF YOUR BUSINESS INTEREST:

- a. Techniques Favoring High-Growth/High Income Asset Transfer (of your business interest)
 1. Intentionally Defective Grantor Trust
 2. Grantor Retained Annuity Trust

3. Family Limited Partnerships or Family Limited Liability Companies

Family Limited Partnerships:

1. Pass-through entity for profits and losses allocated in accordance with the ownership percentages
2. Limited partners' losses are limited to their respective investments in the partnership
3. You can make gifts of your business ownership interest to family members
4. Discounts

Limited Liability Companies:

1. In a family business, the parents retain control
2. Provides for asset diversification
3. Creditor protection
4. Avoids double taxation
5. You can make gifts of your business ownership interest to family members
6. Discounts

AFTER THE SALE OF YOUR BUSINESS INTEREST:

- a. Techniques favoring transfer of your wealth:
 1. Second to Die Insurance and an irrevocable life insurance trust
 2. Charitable lead trust or charitable remainder trust
 3. Family Limited Partnerships and Limited Liability Companies

DEVELOP A CONTINGENT PLAN FOR THE OWNER'S FAMILY

- a. Estate planning is nothing more than one part of the overall business succession plan
- b. Estate planning provides an Exit Plan and funding should the owner exit the business prematurely
- c. The Exit Planning Process implementation often begins with this step - preparation of estate planning documentation and funding

CONCLUSION

At some point, every business owner leaves his or her company - voluntarily or otherwise. At that time, every owner wants to receive the maximum amount of money in order to accomplish personal, financial, income and estate planning goals. It is absolutely necessary to plan for this in advance.

Good luck!