



The Wealth Counselor

A monthly newsletter for wealth planning professionals

Understanding Business Transition Strategies

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As estate planners, we work diligently to help our clients with retirement and estate planning. For business owners, planning for the transfer of the business must be built into the process. An integrated approach to retirement and estate planning is especially important for these clients so they can understand the transfer options that are available to determine and is best for them, their families, their employees and others, taking into consideration current economic times, availability of financing, and financial and non-financial issues. Rather than just taking a salary for life, the client executes and implements the comprehensive plan that we have helped them develop.

In this issue of *The Wealth Counselor*, we'll look at this process and some of the issues involved.

Today's Climate for Business Transfers

Demographics/Competition

The first wave of Baby Boomers applied for Social Security in January 2009. As more of them move closer to retirement, what will happen to their businesses? The sheer numbers of this aging population indicates that there might be two to three sellers for every qualified buyer. This increased competition, coupled with the 2008 stock market crash, will affect business valuations.



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At Price & Farrington, PLLC we work closely with our professional colleagues to help our clients plan, protect and pass their legacies to their loved ones through caring and confidential counseling.

Regulatory Environment

Regulation of the financial market continues to increase, affecting banks, investment houses, insurance companies, broker-dealers, CPAs and valuation experts. More regulation means fewer options for transfers.

Economic Environment

Generally speaking, since 1960 we have had a recession at the turn of each decade. During previous recessions, owners invested in their business, trimmed expenses and laid off employees - whatever it took to keep the business going. They did this knowing that when the recession ended, they would recover and make a return on their investment. But that might not work this time. Many businesses might not survive and recover because the length and depth of a recession is dependent on current government policies for spending, taxing and regulating. With this recession, we have added spending (stimulus, health care and deficits); additional taxes (income, gift, estate); and additional regulation (OSHA, EPA, etc.)

Corporate Finance Environment

Outside financing is more difficult to acquire these days. Typically, a buyer might provide 40% in cash, 40% from lenders and 20% equity. There will be less available from lenders until the capital markets recover from the downturn that started in 2007.

Taxation Environment

Taxation on business owners is increasing with the expiration of the Bush-era tax cuts. Income tax rates are increasing to 39.6% (and even higher with the 3.8% health care tax on higher incomes). We are looking at a first-time Medicare tax on passive income. Long-term capital gains tax is increasing from 15% to 20-28%. If Congress doesn't act, the federal estate tax will return to a \$1 million exemption and a 55% tax rate. The annual gift tax exclusion will drop back to \$10,000. Business valuation discounts, popular with family limited partnerships and LLCs, are under attack in Congress.

Some Key Differences Between Public and Private Companies

Income Tax

Public company CEOs generally don't worry about the amount or rate of income taxation because those costs are passed on to the consumer. Most private companies are "S" corporations and almost all of them pass the income tax burden to their owners, who are obsessed with minimizing or eliminating income taxes.

Planning Tip: For the first time, individual tax rates will be higher than corporate rates. The dividend tax rate is also increasing. Owners and advisors need to look at the business structure to find ways to reduce taxes and maintain cash flow to allow for growth or to make the desired business transfer.

Growth

The CEO of a public company tries to grow share value. Its board of directors will act quickly to remove and replace non-performing management. The owner of a private company seeks to grow family wealth, starting with him- or herself, and has often invested personal assets to start the business or keep it going. The board of directors (if any) is reluctant to make changes to management, who are often family members. If they are not the best choice for the job, company growth can be negatively affected.

Access to Capital

The CFO of a public company tries to obtain capital at the lowest possible cost. The owner of a privately held business has very limited access to capital, taking what they can get, which usually requires a personal guarantee.

Value

A privately held business has multiple values on the same day, which can be obtained appropriately, legally and accurately, depending on the owner's motives and the direction of the transfer. They include: *synergistic value* (a competitor wants to acquire the business for integration or to reduce costs); *market value*; *control value* (Rev. Rule 59-60, 26CFR 2510-13); *minority value* (Rev. Rule 59-60); *non-voting, minority value* (Rev. Rule 59-60); and *liquidation value*, forced or orderly. Frequently there is a "value expectation gap" between what the owner thinks the company is worth and the actual fair market value.

Planning Tip: The economy, the market and trends affect the timing and value of transfers. Most owners can't wait until they reach age 68 and then decide to sell. In most cases, it will be necessary to prepare your client to go to market. Is the owner doing things that are causing the value to increase or decrease? Perhaps there are personal expenses that shouldn't be run through the business.

Private Capital Markets

5.4 million U.S. businesses have sales of \$5 million or less compared to 300,000 that have sales from \$5 million to \$1 billion and only 2,000 that have sales over \$1 billion. Thus, the vast majority of businesses we work with have sales of \$5 million or less. In both good and bad economic times, an appropriate multiple on the open market for this size company is 2-3 times annual sales. Expect to get a lower multiple (1-1.5) for a company that would not survive without the owner continuing to work in it and a slightly higher multiple for one that is strong without the owner's participation.

Business Transfer Spectrum/Uncovering the Client's Transfer Motive

Transfer Channels

Depending on the client's motives, there are a variety of channels through which the transfer can occur. For example, transfers can be made internally - to family members, co-owners, charitable trusts and employees-or externally through auctions and public

offerings. The transfer methods to be used can be determined based on the client's motives.

Family: Gifts; SCINs; Annuities; GRATs; FLPs; IDGTs

Co-Owners: Buy/Sell; Russian Roulette; Dutch Auction; Right of First Refusal

Charitable Trusts: RTs; RATs; RUTs; LTs; LATs; LUTs

Employees: ESOPS; Management Buyout/Ins; Options; Phantom Stock; Stock Appreciation Rights

Outside (Retire): Negotiated One-Step Private Auctions; Two-Step Public Auctions

Outside (Continue): Consolidated Roll-ups; Buy and Build Recaps

Public: Initial Public Offerings; Direct Public Offerings; Reverse Mergers; Going Private

Planning Tip: Go through an "Options Analysis" as an initial phase. Include valuations using various options (products used; strengths and weaknesses). It's much better to uncover the client's motives early on before you spend too much time with one option only to discover the client actually thinks differently.

Planning Tip: Be prepared to spend time educating your client. If the client doesn't understand how to make the transfer, he will keep putting it off. Your job will include helping the client see the transfer through.

How to Make the Transfer Work for Everyone

Frequently, the owner and the recipient of the transferred business will have different objectives. You will need to understand what motivates each in order to make the transfer a successful one. Here are some examples.

Family Transfer

Objectives of Legacy Generation (Owner)

He or she will want to transfer ownership to the children now or after death, maintain his or her current lifestyle, treat the children equally and fairly and, most of all, remain in control.

Objectives of Second Generation

They will want to grow the business, try new ideas, and take risks. They are willing to pay a fair price for the company, and want a clear path and plan for change in control. They are willing to work for a below market wage for a while, but eventually be able to

compensate themselves for their efforts. They want to treat siblings equitably but not have them share in the growth forever (especially if they do not work in the business). And they are willing to pay the parents a reasonable salary for a time, as long as they are contributing to the growth of the business.

Planning Tip: It may be possible for the owner to continue doing what he/she loves doing in the business. Nonworking siblings can be compensated through other planning.

Management/Employee Transfer

Seller's Objectives

Usually the seller is not as comfortable transferring to management or employees as he would be with transferring the business to family members. He may want to remain in control until death or retirement, or at least until paid in full. He may want to make sure the legacy lives on and may even want restrictions on the transfer so he can take the company back if he is not happy with the direction it is going. He will usually want to maintain his current lifestyle and may want a significant cash payment at closing, but does not want to personally guarantee the loan.

Management's Objectives

These are very similar to those of the second generation in a family transfer. They will want to grow the business, try new ideas, and take risks. They are willing to pay a fair price for the company and want a clear path and plan for change in control. They are willing to work for a below-market wage for a while, but eventually want to be able to compensate themselves for their efforts. And they are willing to pay the seller a reasonable salary for a time, as long as he is contributing to the growth of the business.

Planning Tip: The original owner may want to contribute to the company in an area in which he excels; for example, spending time in sales or training a sales force. Also, the seller may have to guarantee a loan for a period of time, especially if he still has some control.

Third Party Transfer

Sometimes the owner needs an infusion of capital to expand the business and may want to participate in the resulting upside. Often the seller wants a significant check at closing (70-80%) in exchange for giving up operating control. Would the seller want to be involved with a small stake in the business but little control? Could the seller become a team player with someone else calling the shots? The seller may not want to stay, but prefer to retire or remain on the board of directors. If family members are involved in the business, they can be compensated/rewarded with proceeds from the owner's personal estate planning.

Planning Tip: The choice of entity will affect the valuation of a private company. Make sure you read and understand the controlling document (bylaws, operating agreement, partnership agreement). Generally, the greater the restrictions, the greater the impact on

the value.

Planning Tip: Why wouldn't the owner just stay on the payroll until he dies? He could, but the company would lose value, and the asset would remain in his estate and would most likely be subject to estate taxes. Planning now to transfer the company will result in the owner receiving the best possible results, both now and after his death.

Conclusion

Be aware of the planning opportunities and needs for clients with privately owned companies. The transfer of the company will need to be incorporated in the client's retirement, estate and income tax planning. These are good networking opportunities and good sources of revenue for you.

GDP/CPF

To comply with the U.S. Treasury regulations, we must inform you that (i) any U.S. federal tax advice contained in this newsletter was not intended or written to be used, and cannot be used, by any person for the purpose of avoiding U.S. federal tax penalties that may be imposed on such person and (ii) each taxpayer should seek advice from their tax adviser based on the taxpayer's particular circumstances.

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You have received this newsletter because I believe you will find its content valuable, and I hope that it will help you to provide better service to your clients. Please feel free to !CONTACTME! if you have any questions about this or any matters relating to estate or wealth planning.

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