The Wealth Counselor

A monthly newsletter for wealth planning professionals

Understanding Business Transition Strategies

Volume 5, Issue 7

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DEDICATED TO HELPING FAMILIES BUILD & PROTECT WEALTH
PREPARE FOR AND DEAL WITH LIFE CYCLE EVENTS

WE PRACTICE IN THE AREAS OF ESTATE PLANNING, ASSET PROTECTION, TAX LAW AND BUSINESS LAW

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As estate planners, we often talk with clients about and work diligently to help them with their retirement and estate planning. For those clients who own a business, planning for the transfer of the business must be built into the process. An integrated approach in dealing with retirement and estate planning is particularly needed for these clients.

We need to help these clients understand the transfer options that are available, and help them determine what is best for them and how it will affect their families, their employees and others. We need to do it in a way that takes into consideration the current economic times, availability of financing, financial and non-financial issues, and how these transactions take place. We need to help them through the process so that, rather than just taking a salary for life, they execute and implement the comprehensive plan that we develop with and present to them.

In this issue of *The Wealth Counselor*, we will 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? Due to the sheer numbers of this aging population, there may be two to three sellers for every qualified buyer. This increased competition, coupled with the 2008 stock market crash, will affect business valuations.

Regulatory Environment

Regulations on the financial market continue to increase, affecting banks, investment houses, insurance companies, broker dealers, CPAs and valuators of all types. 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, 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. That may not work this time. Many businesses may not survive and recover because the length and depth of a recession is dependent on current government policies-spending, tax, and regulation. 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 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 Bush-era tax cuts expiring. Income taxes are going to 39.6% (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 does not act, the estate tax will go back to a $1 million exemption and 55% tax rate. The annual gift tax exclusion will be back to $10,000, and 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 do not worry about the amount or rate of income taxation because those costs will be passed on to the consumer. Most private companies are "S" corporations and almost all of them pass an income tax burden to their owners, so the owner of a private company is 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. Look at the business structure to find ways to reduce taxes and keep cash flow in the business to allow for growth or to make the desired transfer.

Growth
The CEO of a public company seeks 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 himself, 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, that can negatively affect the growth of the company.

Access to Capital

The CFO of a public company strives to obtain capital at the lowest possible cost. The owner of a privately held business has very limited access to capital. He will take what he can get, usually requiring 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 direction of the transfer. These values include synergistic (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); 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, market and trends affect the timing and value of transfers. Most owners cannot 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 go up or down? Perhaps there are personal expenses that should not 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 the 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 then 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 find out 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
Quite frequently, the owner and the recipient of the transfer 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 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 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.

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