Financial planning for business owners contemplating a liquidity event

Taking the time in advance of a potential liquidity event to plan appropriately will help a business owner get the most out of a sale.

In today's world, pursuing your life's goals is being challenged in new ways. Which makes now the perfect time to review your goals in terms of "Advice. Beyond investing." Because when we collaborate on what matters most to you, we can create a plan tailored for you.

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The transfer of full or partial ownership and/or management responsibilities is a significant decision.

In the United States, approximately 54% of Baby Boomer business owners plan on exiting their business within the next 10 years, and while almost all business owners agree that it is important to have a thorough exit strategy in place, 72% do not have a plan and aren't taking action.[1] The decision to exit a business is often very personal and complex for its owner. In order to ensure personal, family and business goals are achieved, a thorough plan should be put into place. Planning appropriately can be an essential component for protecting and preserving the value of an owner's company for him or herself and heirs. Financial advisors and planners are an essential resource to business owners and their families looking to engage in detailed planning prior to, during and after a major liquidity event. This article outlines a few key topics business owners should consider when planning for a sale.

Succession planning

A major issue in contemplating an exit plan is deciding to whom the owner will pass the business. A quarter of Baby Boomers expect to sell their businesses to a third party, while 25% expect to sell to employees.[2] Only about 37% expect to pass the business on to family and 10% expect to close or wind the business down.[3]

If an owner is interested in a merger, acquisition, IPO or private equity deal, he or she should make sure that a team of advisors includes an attorney, accountant, financial advisor and potentially an investment banker who are well equipped to provide advice on transaction structure, ownership transition and post-sale asset management.

If an owner desires to transfer the business to a family member, there are several options. Some owners may not feel ready to relinquish total control of their company and may seek out a partial transfer of their interest or the transfer of a non-voting interest which may allow them to retain some control. When the owner feels ready, he or she can then begin the process of transferring a controlling interest. It is important to remember that a company's structure (i.e., LLC, limited partnership, S-Corporation, C-Corporation) will impact the exact manner in which a transfer of control will be structured.

The transfer of full or partial ownership and/or management responsibilities is a significant decision. Not only must one be psychologically ready to give up ownership and management but the individual taking on an owner/manager role must be willing, capable and mentally prepared as well.

Retirement and financial goals

Often, the decision to sell a business goes hand in hand with an owner's appetite for retirement. If this is the case, it is important that the owner take the time to engage in a retirement conversation and contemplate his or her cash flow needs. The owner must first assess how much annual income he or she will require post-sale, factoring in inflation assumptions as well as potential extraordinary expenses such as buying a vacation home. Other questions include: "Can I live off the value of my current investment portfolio alone?" Or, "will I have to acquire a certain amount of money from the sale to maintain my lifestyle?" Either way, a detailed cash flow analysis will help the owner determine what the future post-sale would look like. A cash flow breakdown will also help the owner determine the ways in which he or she is able to plan for family. Before selling a business, an owner will want to evaluate goals and objectives for his or her family's future and determine the best wealth planning strategies for realizing these goals.

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A business owner planning for retirement should also factor in whether or not the purchaser will require the owner to stay on board for a period of time (often a two or three year commitment). A purchaser may request the owner to maintain employment in some capacity in order to help transition employee management responsibilities, smooth transition of client relationships and provide continued leadership for business growth (new products/services) until proper replacement leadership is established.

The request to stay on for an additional period of time may also have a serious impact on an actual retirement date. A business owner may not wish to work for someone else, but may wish to simply retire and relinquish all business responsibilities to the new owner. This may not be a viable option when selling a business so it may be advisable to plan a sale of the business well in advance of a hard stop date and complete retirement.

Staying on additional years may be financially beneficial and also help secure retirement funding goals. Many times a purchaser may provide either a salary and/or an earn-out based on performance. Regardless, all of these factors should be considered when planning to sell a business.

An important note: often a business owner may pay certain expenses through the business. However, after the sale, the owner will no longer be able to have the business cover these expenses. It is important to assess what these expenses are and how they will impact personal cash flow. Additionally, from the perspective of preparing the business for sale, books and records should be up to date and accurate according to appropriate accounting standards.

Tax considerations

Appropriate tax planning is an essential component of a pre-sale strategy. Liquidity events typically incur income taxes (some or all of the proceeds may be subject to ordinary income or capital gains tax and the 3.8% surtax on net investment income). Comprehensive analysis, including financial and estate planning, before the exit can help an owner understand income tax treatment and potentially minimize his or her estate tax burden by transferring part of the business to family members, trusts and other entities prior to the sale.

Many business owners will assume that the sale of their business will generate a long-term capital gain. However this may not be the case and many times it depends upon the nature of the business and the structure of the sale. Tax treatment can range from tax-free, tax- deferred, ordinary income tax treatment or long-term capital gain tax treatment. The most surprising is when some or all of the sale proceeds are taxed at ordinary income tax rates. This is likely when a business sells the underlying business assets. The type of assets in a business will dictate income tax treatment. For example, so-called "hot assets" (account receivables, inventory or depreciated property) may trigger ordinary income tax treatment on the sale.

Various tax-reduction strategies should be considered. If a business owner lives in a state with high income taxes, one tactic might be to change residency pre-sale. (A discussion of what it takes to change a taxpayer's domicile is beyond the scope of this article, but it is critical to consult with legal and tax advisors to ensure that an intent to change domicile is supported by certain facts and actions). Owners can also use various types of trusts to possibly reduce or eliminate federal and state income and transfer taxes (please see the following article "Five steps for pre-sale estate planning" for further

details on estate and gifting strategies). In addition the 2018 Tax Cuts & Jobs Act has new provisions related to depreciation that need to be taken into consideration.

Determine an investment strategy going forward

For many business owners, the majority of their net worth has been comprised of the company for many years. When they gain additional liquidity, they will need to reevaluate their investment strategy. At the most basic level: what is their risk tolerance? Who do they want to manage their assets? How involved do they want to be? What level of return are they looking for? These questions should be considered before the influx of cash, not afterwards.

Philanthropic considerations

When planning for a sale, owners may want to consider whether or not they want to use some of the proceeds for charitable giving. In fact, gifting highly appreciated assets to a charitable entity might prove useful in reducing the owner's income tax burden as a result of the sale of the business. A transfer of shares to a private foundation or charitable remainder trust before a sale can generate an income tax deduction and possible deferral or avoidance of income tax payable upon the sale. There are very specific rules and further complexity when gifting business interests to a charitable entity. It is important for an owner to consult with advisors to ensure he or she is aware of all the nuances and how it would impact his or her financial plan.

When planning for a sale, owners may want to consider whether or not they want to use some of the proceeds for charitable giving.

Conclusion

Taking the time in advance of a potential liquidity event to plan appropriately will help a business owner get the most out of the sale. The sale of a business involves many considerations and an owner will want to make sure he or she is taking into account all cash flow, wealth transfer, and philanthropic goals while minimizing the overall tax burden. The earlier an owner begins planning, the more savings he or she is likely to incur. Financial advisors and planning teams at UBS can be key resources for clients embarking on this process.

– *David Rosenthal,* Wealth Management Consultant

Five steps for pre-sale estate planning

Estate and wealth transfer planning may not be the top priority for entrepreneurs considering a sale of their business, but it can be a critical component of the pre-sale process. In order to take maximum advantage of certain strategies, it is important to begin thinking about estate planning and wealth transfer well in advance of any sale. Once the business is sold, it may be too late.

1. Determine wealth transfer goals

For many business owners who have dedicated a substantial portion of time and resources to their business, establishing or updating their estate planning documents and wealth transfer goals should be part of the planning process. Before any transfers during lifetime are considered, an important question that should be answered is how much is needed, post-sale to live the lifestyle they want to live. Business owners should assess the amount of assets and/or income needed for use during their lifetimes and be careful that any transfers made do not jeopardize their ability to satisfy their needs.

One variable in this assessment is the structure of the sale. If an owner is used to receiving income from his business, it is important to plan for the replacement of income through reinvestment of sales proceeds. This income review should also take into account the impact of a cash only transaction versus cash and equity, and lump sum proceeds versus a deferred payment schedule. Living expense requirements must also be considered. Expenses may increase post-sale if the owner has more leisure time to travel or indulge in other discretionary expenses, or if the business was subsidizing some expenses on behalf of the owner such as health care costs or transportation expenses. It may take time and thoughtful analysis to find a balance between long-term lifestyle needs versus potential estate tax benefits.

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2. Review business structure

Depending on the ownership and structure of a business, the operating, partnership or shareholder's agreement may need to be revised to allow for the transfer of ownership for gifting purposes. Sometimes, in order to allow for a transfer of ownership but not control, the structure may need to be changed to separate the ownership of the business from the management or control of the business. For example, an S corporation (a closely-held corporation that generally has pass-through status for income tax purposes) may be re-capitalized into voting and non-voting shares or an LLC may be reformed so that it is a manager managed LLC versus a member managed LLC. The transfer of non-voting or non- controlling units may be done at a lower value due to lack of control discounts that may be applied to these types of ownership interests. If a sale is imminent, a potential deal may not allow for any changes as the buyer (or seller) may not want to risk making any modifications to the structure of the business.

3. Obtain a valuation

Another critical component for both wealth transfer planning and pre- sale planning is to establish a valuation of the business. Prior to any transfers, a professional, independent valuation should be completed by a qualified appraiser. For gift tax purposes, a donor might hope for a lower valuation which would result in lower potential transfer taxes associated with a gift of the business. An appraisal of a business being used for wealth transfer purposes may take into account discounts for lack of marketability and lack of control as discussed above. These discounts may allow a transfer to occur

at a lower gift tax cost. Conversely, when valuing a business for sale purposes, a higher valuation would be preferred by the business owner to maximize proceeds. Regardless, the appraisal must be conducted by an independent professional.

Time is an important factor in ensuring that necessary steps, such as a professional valuation, may be completed. If the likelihood of a sale is uncertain or currently unforeseeable, the valuation for gift purposes may be significantly different than a potential future sale price. If an impending sale is close to being finalized, it may be difficult for an appraiser to substantiate a valuation that is lower than the pending sale price. It may also be difficult to justify a discount for lack of marketability if the asset is close to being sold.

4. Evaluate the strategies

Below are a few of the most common strategies that may be considered when making gifts of business interests. While these may be implemented after a business is sold, they may have a significantly greater impact if completed prior to a sale.

Gift of ownership

A gift of shares or business interests will generally use the donor's lifetime gift tax exemption $11.2 million in 2018 for an individual and $22.4 million for a married couple, indexed for inflation. (However, on January 1, 2026, if the exemption "sunsets" the exemption will return to $5.6 million for an individual and $11.2 million for a married couple) as indexed for inflation from 2018 to 2025.) Such a gift may be made either outright or in trust. While an outright gift may be the simplest, making a gift in trust may have the additional benefit of providing some asset protection from third parties and may allow the donor to retain some level of control. The donor will need to choose appropriate trustee(s) and successor trustee(s), decide how long the trust will last and when a beneficiary may access the trust assets. While trusts may provide certain benefits, the process of creating a trust takes time, and involves added legal expenses. Depending on how financially savvy the beneficiary is and how much is being transferred, keeping assets protected in trust may or may not be a material concern for a donor.

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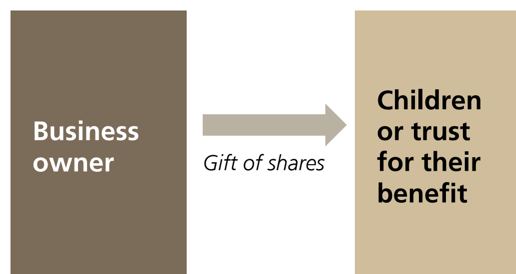


Whether the gift is made outright or in trust, the sooner the gift is made, the sooner the potential growth on the asset will begin compounding outside of the estate. Depending on the valuation of the business and the potential for discounts for lack of marketability or control, making the gift ahead of time may save significant estate taxes.

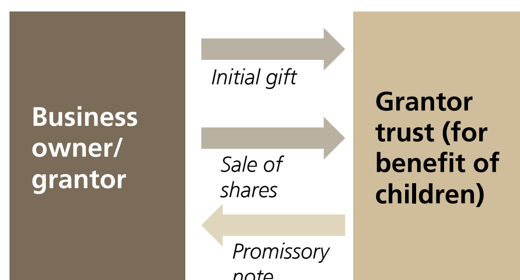
Sale of shares to a trust

Rather than making a gift of shares, the shares may be sold to a trust for the benefit of the business owner's family. Typically, the owner sells the shares to the trust in exchange for a promissory note with an interest rate based on the

term of the note and the published IRS rate for that month. Assuming that the sale price is considered fair market value, there is no gift tax implication associated with the sale for the owner. If the assets appreciate at a higher return than the note, the additional growth will accumulate in the trust rather than in the business owner's taxable estate.

The trust purchasing the shares will often include provisions that cause the IRS to view the business owner or grantor as the owner of the trust assets for income tax purposes. That means that the grantor pays the taxes on the trust income. The grantor is able to subsidize the growth of the trust by paying for any income taxes incurred. (Therefore, it is important to confirm that the grantor's cash flow can absorb this expense). In addition, the sale of shares to a grantor trust will not cause a capital gains tax for the grantor/seller since transactions between the grantor and the grantor trust typically are ignored for income tax purposes.

It is typically advisable for the trust to own at least 10% of the total sale amount. This may be accomplished by making an initial gift to the trust. Consult with an estate planning attorney before any transaction occurs to review the overall structure as well as initial funding of the trust.



If the sale to the trust is accomplished prior to the sale of the business to a third party, the appreciation on the value of the shares in the trust could be significant since the initial sale to the trust may occur at a substantial discount to the ultimate sale price to a third party.

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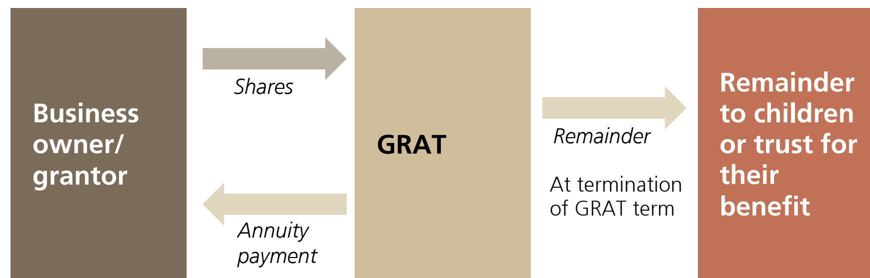
A Grantor Retained Annuity Trust (GRAT) allows a business owner to transfer shares to a trust and receive an annuity payment back over time. Any assets left after the final annuity payment is made may pass on to children or a trust established for their benefit, outside of the business owner or grantor's estate. Often, the trust is structured to maximize the annuity payment so that the grantor can expect to receive the full amount of principal contributed back, plus an assumed IRS growth rate. If structured in this manner, there may be little or no transfer tax cost. The annuity payment is predetermined in the trust document based on the IRS assumed growth rate (or 7520 rate) published each month, the term of the trust, and the value of the initial gift to the trust and will not change even if the asset contributed grows in excess of the IRS rate.



This trust is structured as a grantor trust and will include provisions that cause the IRS to view the business owner or grantor as the owner of the trust assets for income tax purposes so that the grantor pays the trust's income taxes.

A GRAT may allow a business owner to retain principal yet give away potential future appreciation of a business prior to a sale with minimal gift tax consequences.

5. Implementation

Prior to undertaking any strategy, it is important for the business owner to coordinate with the appropriate advisors such as an estate planning attorney, tax advisor, financial advisor, and business appraiser. Creating a written plan that outlines the strategy, timeframe and next steps may be helpful to ensure that all parties are working together.

Conclusion

Although the strategies above have focused on pre-sale wealth transfer, a comprehensive plan should also account for what might happen in the event a sale does not occur. Some owners may feel differently about how they choose to leave their assets if a business still comprises a majority or even just a portion of their estate. If there is uncertainty whether the surviving family members would be able to successfully continue business operations or if not all of the family members are involved in the business, there may be additional planning required to ensure smooth transition of the business and equalization of the estate. Reviewing business succession planning and/or the buy-sell agreement regularly is an important component of business management, both as part of pre-sale considerations as well as ongoing estate planning.

– *David Rosenthal,* Wealth Management Consultant

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See important notes and disclosures on the next page

[1] 2015 Securian Financial Group Small Business Owner Life Stage Study.
[2] Ibid
[3] Ibid

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