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Avoiding Disaster in Business Transfers to Insiders

Steve Smith was no different than millions of other baby boomer business owners in that the thought of leaving his business was never far from his mind, no matter how far away his exit might be. He daydreamed about transferring the business to his oldest daughter and perhaps to a member of his management team, yet he couldn't gauge their passion for owning a business, and hadn't tested their management skills.

And, of course, they had no money.

Steve's company was his economic and financial lifeline. Without its income, without his ability to use the business to accumulate wealth, without the ability to sell his interest to a buyer who had cash, and without a plan, Steve's wishes would remain wishes. To Steve, it was obvious that if he ever wanted to exit his business in style, he needed to wait for a white knight buyer to appear on his doorstep bearing saddlebags full of cash. So, Steve did what many, many other owners in his position do: nothing.

If you think that transferring your business to your children or to your management team is inherently risky, you are right. Insider transfers are risky because:

1. Insiders have no money.
2. Successors' management / ownership skills and commitment to ownership may be untested.
3. You lose control of the business if you make the transfer before you are completely cashed out.

On the other hand, the *possible* benefits to this type of transfer include:

1. Keeping the business in your family or extending your legacy through your hand-picked management group.
2. Motivating, retaining and rewarding key employees.
3. Reaping more after-tax money than a third party transfer.
4. Retaining control until all, or most, of the purchase price is received.
5. Remaining active in the business while gradually reducing your day-to-day responsibilities.
6. Providing time for you to build up personal assets (via distributions of cash) before your exit.

The trick is to design a plan that minimizes each risk so you can reap all of the potential benefits. Let's first look at how that might be done.

1. **Insiders have no money, therefore it is too risky to sell to them.** That's true if you don't design a transfer strategy that puts money in their pockets as they increase the value of your company. Years in advance of the transfer, you will have to work steadily and effectively to build cash flow (the source for all cash out) through the installation of Value Drivers and through careful planning to minimize taxation.

Unless you carefully plan to avoid it, cash flow can be taxed twice. This double tax (sometimes totaling more than 50 percent) can spell disaster for many internal transfers. Through effective tax planning, however, much of this tax burden can be legally avoided.

Finally, you and your advisors (including a certified business appraiser) should use a modest, but defensible

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valuation for the company. Because a lower value is used for the purchase price, the size of the tax bite is correspondingly reduced. The difference between what you will receive from the sale of your business, at a lower price, and what you want to be paid to you after you leave the business is “made good” through a number of different techniques to extract cash from the company after you leave it.

2. **Successor’s management/ownership skills are untested.** If that’s the case, create a written plan to systematically transition management and ownership responsibilities to your successor--beginning today. The transition period, during which you test both your assumptions and your successors’ skills, usually takes several years to complete.

3. **You lose control before being cashed out.** This is only true if you (and your advisors) fail to implement a transfer strategy designed to accomplish the opposite: you are cashed out *before* you lose control. In such a plan, you keep control, in part through a well-designed and incremental sale of the company, over time, based upon improving company cash flow over time.

The keys to reducing the risks of an insider transfer necessary to achieve success are:

1. Plan the transfer well in advance of your desired exit date. Executing an insider transfer takes longer than executing a sale to a third party.
2. Value building activities are just as—if not more—important to an insider transfer as they are to a sale to a third party.
3. Plan design must be tax sensitive.
4. The Plan must be in writing and make advisors accountable.

The examples provided are hypothetical and for illustrative purposes only and do not represent actual client experiences. Subsequent issues of The Exit Planning Review™ provide balanced and advertising-free information about all aspects of Exit Planning. We have newsletter articles and detailed White Papers related to this and other Exit Planning topics. If you have any questions or want additional Exit Planning information, please contact us.