A Multi-Disciplinary Process for The Parent-Child Business Transfer Your Client Thought Was Impossible

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Attorneys must frame Exit Planning as more important than owners realize

- *The number of baby boomer owners that will be leaving their businesses in the next 10-years is staggering*
- Most business owners want to exit their businesses within the next 10 years
- Most business owners believe that their exits will occur because of planning and action items they implement
- Most business owners have not created concrete, written plans for their exits
- Owners talk about their exits with the people they trust (e.g. Bus Atty: 25%; Estate Planning Atty: 15%)
- Only 18% had talked to an Exit Planning Advisor, implying that:
  1. Owners are probably not getting a full picture of what Exit Planning entails
  2. Owners don't realize advisors can help them with Exit Planning
- In the end, TRUST is key

TYPICAL SALE TO CHILD: A DISASTER IN THE MAKING

THE DILEMMA

Insiders (children/employees) don't:

- Have much money
- Have much credit

TYPICAL SALE TO CHILD:

- Low or no down payment
- Owner finances purchase with promissory note
- Child makes payments with post-tax dollars
- Owner pays capital gains on receipts

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Multi-Disciplinary Approach Exit Planner Manages A Professional Advisor Team, Which May Include:

- Financial Planner
- Insurance Advisor
- Investment Advisor
- Business Attorney
- Estate Planning Attorney
- CPA
- Business Valuation Specialist
- Investment Advisor or Business Broker
- Banker
- Business or Management Consultant
- Family Business Consultant

The Exit Planner will be an attorney or other professional advisor who is specifically trained to use an exit planning process, such as the Business Enterprise Institute ("BEI") 7-Step Exit Planning Process.™

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THE SIX INGREDIENTS OF A SUCCESSFUL TRANSFER TO A CHILD OR CHILDREN:

Ingredient 1: A Tried and True Process, e.g. BEI Seven Step Exit Planning Process™

Ingredient 2: Parental Financial Security

Ingredient 3: Ownership Based on Merit, not Emotion

Ingredient 4: Fairness to *All* Children

Ingredient 5: A Capable Successor, Prepared Business and Ready Owner

Ingredient 6: A Back-Up Plan

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Ingredient 1: Exit Planning Process: BEI 7-Step Exit Planning Process

Step 1 – Identify Exit Objectives

Step 2 – Quantify Business and Personal Financial Resources

Step 3 – Maximize and Protect Business Value

Step 4 – Ownership Transfer to Insiders

Step 5 – Ownership Transfer to Third Party

Step 6 – Business Continuity

Step 7 – Personal Wealth and Estate Planning

The 7-Step Exit Planning Process™ is not the only process designed for use in Exit Planning. Most other processes incorporate all or most of the steps that comprise the 7-Step Exit Planning Process™

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Exit Planning Process: Steps 1, 2 and 3

Step 1 – Identify Exit Objectives	• Basic goals: when; to whom; and for how much ("Financial Goal") • Aspirational e.g., Keep business in community
Step 2 – Quantify Business and Personal Financial Resources	• Financial Goal – (Business Value + Non-Business Resources) = the "Gap" which must come from the business
Step 3 - Maximize and Protect Business Value	• Promote Value through "Value Drivers," e.g., increased cash flow; motivated and stable management team; diversified customer base

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Exit Planning Process: Steps 4 - 7

Step 4 –Design and Implement Transfer to BAC	• Owner maintains control until exit or when feels comfortable transferring it; Financial Goal secured; Minimize tax and other risks
Step 5 – Preserve Option for Third-Party Sale	• Do nothing to preclude a sale to a third party (as a back-up plan) should the transfer to a child fail through.
Step 6 – Business Continuity - Backup Plan	• Contingency plans to ensure continuation of business, if owner or successor dies before transfer is complete.
Step 7 – Estate Planning	• Coordinate estate and gift planning with owner's exit plan; provide for Non-Business Active Child and Business Active Child as parent's sense of fairness dictates.

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Ingredient 2: Parental Financial Security

- A parent child transfer must yield financial independence. Otherwise, it isn't a plan; it is a liquidation or a train wreck, but not an exit plan.
- Can be more pressure for parent to cede control in a family transfer than a transfer to Key Employees

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Ingredient 3: Ownership Based on Merit, Not Emotion

Performance Standards

- Motivate and reward successor and employees to increase enterprise value and cash flow—over time
- Use non-qualified deferred compensation for non-family key employees / Ownership to family key employees.
- Design performance standards which further parent's goals and objectives
- Can be used to determine allocation of ownership among children

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Ingredient 4: Fairness to All Children

- Is it really unfair to Non Business Active Children ("NBACs") if the business goes to a Business Active Child ("BAC") who:
  - Is, in effect, paying for the business through "sweat-equity" (lowered compensation, more working hours, and greater risk)?
  - Has added and continues to add value to the business through his/her efforts
  - Will, by continuing the business after owner leaves, become a critical element in the owner's retirement plan?

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Challenges of One-Child Ownership

Value: The value of the business may be significantly greater than the combined value of the parent/owner's remaining assets

- **Timing:** There are income tax and estate tax benefits to transferring a significant amount of the business to the Business Active Child during the parents' lifetime.
- Non-Business Active Children rarely receive *their share* of the family wealth until after the parents die.

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Ingredient 5: Capable Successor

A capable successor will have demonstrated an ability to manage day-to-day operations?

And:

- Drive business growth?
- Anticipate and respond to outside threats, e.g. new competition?
- Navigate during economic downturns?
- Exercise leadership?
- Manage the management?

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Ingredient 5 (Con't): Prepared Business

Prepared Business:

- Owner has planned for the business's future without him/her?
- Repeatable systems
- Varied customer base
- Management capable without Owner's presence
- All Value Drivers implemented

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Ingredient 5 (Con't): A Ready Owner

Ready Owner:

- Has planned for his/her future without the business?
- Is satisfied that a transfer to this child will achieve all his/her exit goals?
- Is ready to leave?
- Is prepared to transfer control if BAC performs as specified?

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Ingredient 6: A Back-Up Plan: What if ---

- Owner dies or become incapacitated before the transition is complete?
- Business is or becomes so valuable that the chosen successor child cannot financially manage a buyout?
- If BAC child acquires ownership of the business: Can the owner provide assets of appropriate value to NBAC?
- Over time, owner learns that the BAC no longer has the drive or interest necessary to run the business successfully?
- You discover that management style and practices of your BAC differ significantly from yours?
- A child (BAC or NBAC) gets divorced?

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Back-Up Plan: Benefits to the Owner

- Objectives can still be achieved if owner doesn't survive his/her exit.
- Owner retains ownership and control of company if co-owner departs.
- Can force non-contributing owners to leave the business.
- Provides consistency between lifetime and death objectives.
- Ensures survival of the business for the benefit of others.
- Results in family receiving value of owner's interest, in cash.

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Business Continuity Planning

Questions for Owner

- If I die or become permanently disabled tomorrow:
- Will my family be able to maintain the lifestyle I want for them
- Will my business survive?
- Will my business transfer according to my wishes
- Will my other goals, including my Values-Based Goals, be achieved?

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Death of a Co-Owner: Funded Buy Sell Agreement is not Enough

- Fully funded buy sell agreement will pay deceased owner's family the full value of his or her business interest – but the income from the insurance proceeds will be far less than the income the deceased owner currently provides
  - Consider: additional life insurance; disability income insurance; salary continuation agreement
- If buy sell agreement not properly funded, surviving owner will have to pay the unfunded portion, and the decedent's family will have to rely on the surviving owner to do so

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Death of a Co-Owner: Fully Funded Buy Sell Agreement Won't Ensure that the Business Continues

- Can the business continue without the deceased owner's personal guaranty of debt, leases, surety bonds, etc.
  - Consider additional life insurance
- Will the business be able to continue without the deceased owner's skills
  - Groom managers to replace those skills

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Death of a Sole Owner: No Co-Owner to Buy Deceased Owner's Interest

- Consider "stay bonus" for key employees
- Focus on creating Transferable Value
- Management transition plan
- Consider additional life insurance to substitute cash for personal guaranties
- License or other key agreements to the current business entity
- If business cannot survive without owner – create short-term plan to run it until it can be liquidated in an orderly fashion (include stay bonus, life insurance to pay-off debt, written continuity instructions

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Virgil Vale HVAC Corp. Case Study

- Virgil's Exit Goals:
  - Departure time frame: 7-Years
  - Chosen successor(s): Jill, his daughter
  - Cash needed for retirement: $6 Million
- Current Business Value: $1,000,000
- Personal (Non-Business) Liquidity: $3,500,000
- Company Cash Flow: $250,000

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Virgil's Gap Analysis

Financial Goal	**$6,000,000**
Non-Business Assets	$3,500,000
Needed from Business	$2,500,000
Current Business Value	$1,000,000
Gap	$1,500,000

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Filling the Gap

Question: How does Virgil expect to grow the value of the business from $1.0 million to $2.5 million in 7-years?

Answer: He doesn't. The Exit Planning objective is not to triple business value. It is for the Virgil to receive $2.5 million after tax from his business over the 7-year period.

"…business value is not the key financial factor in transfers to management or children. Cash flow is. The essence of closing the gap for most owners is increasing the company's cash flow at a rate quickly enough to exit on the desired departure date." Exit Planning: The Definitive Guide: Sell Your Business When You Want for the Money You Need to the Person You Choose," pp 96-97, John H. Brown, 2016 (Available on Amazon).

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Where will the Money Come From?

- Performance Standards: Jill earns stock purchase incentives for increasing cash flow
- Virgil will receive money from 4 sources:
  - Increased value of remaining equity
  - Increased salary and distributions
  - Employee payments on stock purchases
- Non-Qualified Deferred Compensation
- Control! Exit can be delayed if goals aren't met

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Final Cash-Out

- Jill obtains lender financing
- Purchased minority equity serves as down payment
- During the transfer period Jill has:
  - Demonstrated management ability, as responsibilities have transferred per schedule;
  - Established creditworthiness
  - Purchased almost 50% ownership (collateralizes loan)
- Virgil maintains control until fully paid or until comfortable relinquishing it to Jill
- Virgil can delay exit if goals not met

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Plan Design Features

- May "jump-start" through stock or cash bonus
- Time: sufficient for gradual transfer and to grow cash flow and value
- Key employees' incentives designed to increase cash flow and value
- Jill can buy stock if meet goals for year
- Minority Discounting on Jill's purchases

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Plan Design Features (cont.)

- Owner receives money from multiple sources
- Non-Qualified Deferred Comp to Virgil further reduces valuation
- Increases in stock value based on improved performance
- Consistent Valuation Formula for IRS Purposes
- Owner remains in control until financial goal met

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Insider Transfer Strategies: Stock Bonus

- Business with sufficient cash flow to support the stock bonus strategy
- Parent wants to expeditiously transfer significant equity to a Business Active Child while minimizing tax impacts;
- Parent has sufficient non-business assets – payment for the transferred equity not a concern
- Can transfer significant equity in one year tax efficiently
- Additional Uses of Stock Bonus:
- "Golden Handcuffs," or an incentive, if a "substantial risk of forfeiture" is attached
- "Jump Start" Business Active Child's (or key employee's) acquisition of company by future stock purchases

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Insider Transfer Strategies: Stock Bonus (Con't)

- The following is one way to use a stock bonus in transferring a business to insiders:
  - Award Business Active Child a stock bonus
  - The Business Active Child will owe income tax on the stock bonus
  - Award the Business Active Child a cash bonus sufficient to cover income tax on stock bonus; gross-up cash bonus so that it also covers the income tax on it
  - Company receives a deduction for the amount of the stock bonus plus the amount of the cash bonus; essentially, the company uses the money it would have paid in income tax on the amount of the stock and cash bonuses for the cash bonus which funds the Business Active Child's income taxes on the two bonuses

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Transfer to Child: Advantages

- Owner can receive amount he/she needs or wants even if Supported by business value
- Owner can remain in control until fully paid
- While receiving income and in control, Owner has time to prepare him/herself, the business and the successor children for post-sale life
- Availability of income tax strategy unique to family transfers
- Options if something unexpected happens, e.g., sudden disability
- Values-Based Goals, e.g. family identity fulfilled
- Buyer prequalified

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Transfer to Child: Disadvantages

- Transferring to child who can't or won't operate the business properly
- Family dynamics can cause Owner to transfer control before Owner achieves financial independence and before children properly prepared to run business
- Payment takes longer than third-party sale; Owner exposed to general business risk
- Children may be unable to run business without Owner, or squabble among themselves
- Tax planning critical
- Family discord – communications among family members must be managed

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Special Considerations in Transferring to a Child

- Target Proceeds may be determined more by need than valuation
- Children in and outside the business
- Availability of income tax strategies unique to family transfers
- Values-Based Goals, e.g. family identity; children's expectations
- Multiple layers of complexity with unexpected death/disability

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Advantages of Exit Planning Approach When Planning for a Parent-Child Transfer

- Primary process or integrated with a business succession process
- Integrates all points of view into single, unified strategy
- Organizes Parent's priorities; focuses on Parent's objectives
- Structure: the 7-Steps segment the process into manageable portions
- Time Bound; Accountability
- Flexible
- Can be useful in overcoming parent/owner resistance and reducing anxiety
- Can provide resistant parent/owner with predictability; safe harbor within business succession process
- Can separate planning which can be accomplished in a relatively short period of time from family dynamics work, which can take much longer

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Some of the Legal Tools Used in Exit Planning

- Employment Agreements
- Stock Bonus
- Deferred Compensation
- Buyback Agreement
- Deferred Compensation
- Phantom Stock
- Stock Appreciation Rights
- Salary Continuation Plan
- Buyback Agreement
- Stay bonus
- Cash Bonus
- Vesting; Forfeiture
- Shareholders' Agreement
- C corp to S corp
- Recap
- Shareholders' Agreement
- Personal Guaranty
- Promissory Note

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Questions?

THANK YOU

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