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Formulating Your Business Succession Plan

Ownership of a business frequently represents years, if not decades, of hard work and entrepreneurial savvy. Still, even the most astute business owners are often unfamiliar with the complexities and meticulous preparation that must go into a successful succession strategy.

Whether you're contemplating transferring your business interest to family members, liquidating assets or selling your share to current management or an outside party, you have decisions to make and complex issues to address.

Common considerations include:

What do you really want for yourself, your family members, your employees and the business itself?

Which transaction structures are relevant to your specific circumstances and goals?

What are the tax implications of the various alternatives available to you?

How much is your business actually worth? What can you do to increase its transaction value and liquidity?

What are the first steps?

Ideally, you should start planning for this major life event at least two years before it actually occurs. It is also important to be supported by a team of financial specialists versed in the succession planning process — and it is vital that your support team operates with a full understanding of your personal vision and comprises the acumen and experience to help you achieve it.

Who Should Serve on Your Advisory Team?

Regardless of the size and complexity of your transaction, you may want to engage legal counsel, an accountant, an investment banker or business broker and, of course, your Financial Advisor. If you are considering transferring your business ownership and interests from your estate to your family, you will likely not need an investment banker or business broker — but an outside business appraiser would still be suggested.

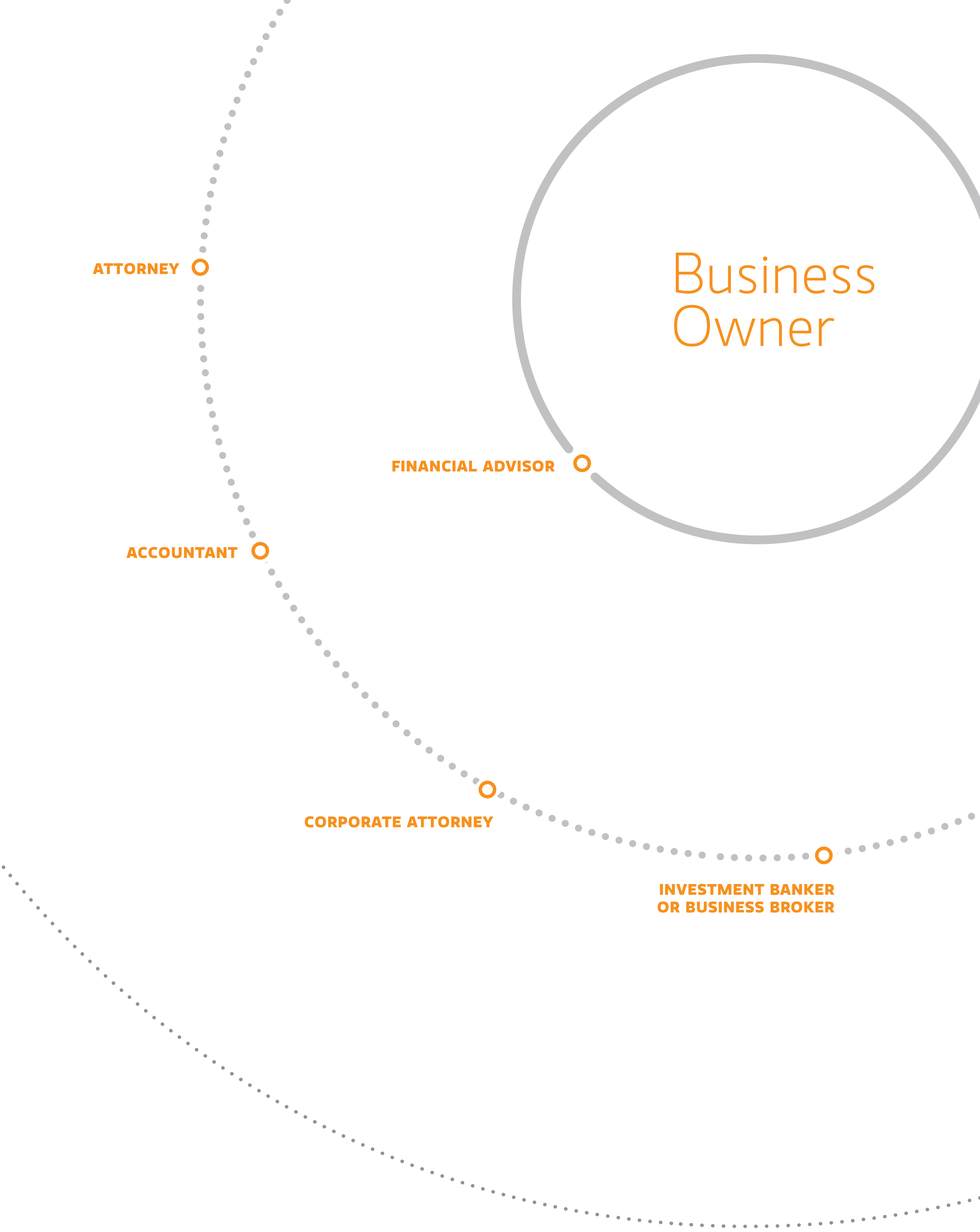
Consider the following when finalizing your choices:

Your attorney may have worked with you in the past on contracts, litigation and other legal issues, but is he or she well versed in the intricacies of purchase and sale agreements and wealth transfer? Occasionally, you may have to appoint new attorneys who specialize in these respective disciplines. For instance, a corporate attorney will work with each party to make sure that any necessary regulatory or third-party approvals are secured, help get documents signed and ensure money properly changes hands between buyer and seller.

Your accountant may be the same CPA who prepares your corporate tax returns each year, but you should understand that transferring or selling a business can trigger a substantial tax liability. Choose an accountant with extensive experience in minimizing the tax impact of monetizing or transferring a business.

An investment banker, business broker and / or third-party business appraiser will analyze your business and the competitive environment to arrive at a realistic valuation. These professionals can also provide valuable input in structuring your transaction.

Your Financial Advisor sees the big picture. He/she understands your succession in the context of your overall financial picture and can help protect the connections between your personal objectives and business ambitions. He or she can work with your other advisors to help them understand your priorities and make certain they are reflected in your succession strategy. ■


Business Owner
ATTORNEY
FINANCIAL ADVISOR
ACCOUNTANT
CORPORATE ATTORNEY
INVESTMENT BANKER OR BUSINESS BROKER

Beginning the Planning Process

Whether you're considering selling or transferring your business, you should begin to plan your transaction at least two years before you hope to complete it. In addition to assembling your advisory team, here are a few things you should consider:

What are your goals? Where do you want to be in three, five or ten years? Do you want to remain involved with your company, or start another? Maybe you're ready to redirect your entrepreneurial energies toward philanthropy or simply enjoying a well-earned retirement. In the words of that great financial sage, Yogi Berra, "If you don't know where you're going, you may not get there."

What are the goals of other stakeholders? If you're thinking about selling your business, are you the sole owner? If not, are your partners on board, or do you foresee potential conflicts down the road?

What Does Preplanning Involve?

Conduct Market Analysis

Commission your investment banker or business broker to conduct an analysis of the market environment, so you can determine:

The potential buyers, and their appetite for transactions

What buyers are looking for in an acquisition target

What valuations are reasonable, and what you can do to maximize your business' valuation potential

Explore and Evaluate Multiple Exit Strategies

Our investment banker or business broker should also develop alternate strategies for you to consider — beyond simply selling your business to a potential buyer. Many business owners have made their successful exit through a sale to an employee stock ownership plan (ESOP) or a private equity group, and others have unlocked liquidity through a recapitalization of the business. By exploring multiple options, each of which has its own pros and cons, you can sometimes expand your pool of potential buyers or investors and realize greater value from your transaction.

If you're planning to transfer your business to a family member, do you have reservations about whether that family member is ready to succeed you in taking over and running the business? What about other family members — will they resent your decision? Is there anything you can do to provide them with an equally significant legacy?

Other stakeholders whose interests need to be taken into account include employees, key customers and suppliers. If you have been integrally involved in your business and the relationships you have formed with the stakeholders are the foundation of your business, it is important to appropriately present and time the communication of your planned transition.

The key is to start thinking about these issues while there is adequate time to prepare for them. In some instances, this may allow you to discover options you didn't even know were available to you. ■

Review Your Company's "Curb Appeal"

If you were selling your home, you would do whatever you could to enhance its "curb appeal." The same goes for your business. Have discussions with your attorney, accountant and other advisors to prepare your company for sale and identify issues that might give pause to a potential buyer by asking:

Have you done what you can to lock in key employees?
Do you have key-person insurance in place?
Are your financials audited?

Who are your key customers, and do you have contracts with them?

What about key suppliers and contractors?
Are they under contract?

Speaking of contracts, do they all contain change of control provisions?

Have you formalized your business processes, and are they efficient?

What threats does your business face?
What are you doing to mitigate them?

What are your business' chief strategic priorities and are they in-line with what buyers want?

From this point on, running your business should focus on what you can do to make it more attractive to potential buyers — which is likely a distinct shift in focus from current practices.

Review and Update Your Financial and Estate Plans

Don't wait until negotiations to realize that you should have updated your financial plan. Take the time now to consult with your CPA, attorney and Financial Advisor about how much you will need to achieve your retirement goals, start a new business or pursue whatever it is you plan to do once you've made your exit.

You should also take this opportunity to review estate planning issues beyond your will with your estate attorney. Update the way your personal and/or business assets are titled, if necessary — and remember that it may take significant time to implement the complex strategies used to transfer assets and minimize your tax liability.

Finalizing Your Plan

Once you're within two years of your planned exit, you should be focusing on growing the company to increase its valuation and on creating a cash flow machine that buyers can envision taking over with minimal changes. If you are transferring your business, this is the time to complete any gifting strategies that you and your advisory team have formulated (see sidebar).

Review your market analysis. Remember the analysis you had your investment banker or business broker conduct several years ago? Consult them again about performing a second analysis to determine how markets have changed and what your strategic priorities should be.

Identify your growth levers and push them full speed ahead. To maximize the attractiveness of your business, identify what drives growth and focus your attentions accordingly. If you have partners who are not on board, consider a strategy in which you or the business would buy out their equity stake. Uncommitted owners can be challenging to a successful sale.

Continue cleanup. Many of the tasks outlined on pages 4 and 5 are ongoing in nature. Focus on those you haven't yet completed to convince potential buyers that your business can be transferred without endangering future cash flows and profits.

Know the negotiating process, and tell your team what is really important to you. Negotiations can be hectic and taxing, and you need to understand what you'll encounter beforehand. Consult with your advisory team and make sure you know how the process works and what points are expected to be critical. Conversely, make certain your team is aware of your priorities and how they fit within the overall context of your wealth management strategy. ■

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Transferring Your Business to Family Members: Three Strategies to Consider

STRATEGY	WHY	WHAT'S INVOLVED
Systematic Gifting	• Gets relatives involved in running the business while you're there to train them. • Maintains more control and provides you with time to transition ownership comfortably. • Removes future appreciation from your estate. • May be able to take advantage of valuation discounts that reduce the value of the gift for gift tax purposes (see page 8).	• Currently, the Internal Revenue service (IRS) allows you to make annual gifts of $14,000 a year (called the Annual Exclusion Amount) to as many people as you wish without incurring gift tax ($28,000 per married couple). • The estate and gift tax exemption is $5.34 million per person and $10.68 million per married couple in 2014. • Valuation discounts may enable you to reduce the value of your gift for tax purposes due to lack of marketability or recipient control. Consult with your attorney for further details.
Family Limited Partnership Note: Similar valuation discounts may also occur through the use of a Limited Liability Company (LLC)	• Allows you to maintain full control of the business while reducing the value of your taxable estate. • Reduces the value of assets placed in the partnership for tax purposes via valuation discounts. • Protects limited partners against creditors and litigation.	• Initial partners, typically parents, form a family limited partnership by contributing shares of the business and receive partnership units in return, thereby assuming the role of general partner. • Children or other family members are given limited partner units. • General partners make all decisions related to the operation of the partnership, including investment of assets and distribution of income; limited partners may receive distributions from partnership but are not entitled to make operating decisions. • Units given to limited partners are not readily marketable, nor do they entitle limited partners to participate in operating decisions. As a result, they may qualify for valuation discounts.
Grantor Related Annuity Trust (GRAT)	• Provides annual income distributions over the term of the trust. • Removes future appreciation of business interests from your estate. • Future appreciation of business interest may be transferred gift tax free.	• Once this trust is established, business interests are gifted to it. • You receive specified income distributions over the term of the trust. • At termination of the trust, business interests pass to beneficiaries without gift or estate tax liability. • Business interests will revert to your estate if you do not survive the term of the trust.

Negotiations

Congratulations! You've found a potential buyer. Negotiations, however, are not for the faint of heart. In addition to the stress that accompanies them, negotiations can divert your focus from running your business and maximizing its growth. Keep the following issues in mind:

Running the company is still your top priority

Don't forget that the growth of your business is still being measured. In recent years, a frequent obstacle to finalizing a deal has been missed profit expectations late in the game.

Confidentiality is key

Lack of confidentiality among you, your partners and your advisory team can create ill will and compromise all the careful planning you've done over the past several years.

Create a list of what you'll need to keep your focus

It may sound ridiculous to compile a list of thoughts like "gain the full support of your spouse" and "delegate when possible," but the pressure of conducting negotiations while you're trying to run your business and lead a satisfying personal life can take its toll. Just as you keep a calendar for your appointments, keep a list that reminds you to do things like make sure your personal phones are unlisted, schedule regular progress meetings with management, leverage your trusted advisors and get yourself to the gym a few times a week.

Anticipate the key points of the negotiation

Understand the various alternatives that might be available to you. How the purchase will be made — through stock, cash or both — is certainly an issue to consider, as is the possibility of an earn-out with specific benchmarks that will be used to evaluate success. If your company is going public or being purchased by a public company, you might find yourself subject to SEC regulations that dictate how long you must hold stocks and when you can sell them. Consult with your accountant, attorney and Financial Advisor to understand the ramifications of decisions you might make. Also, get acquainted with strategies like 10(b)5-1 trading plans, which enable you to comply with SEC regulations while providing yourself with liquidity and the ability to hedge against the risk of an overly large stock position.

Consider your future status

PERHAPS THE MOST COMPLEX ISSUE IS your future status. Will you continue to be an owner, or will you suddenly find yourself an employee?

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A WORD ABOUT VALUATION DISCOUNTS

With valuation discounts, you give shares of a business to a family member, but the shares are not marketable and they do not entitle the recipient to make any operating decisions.

As a result, the value of these shares can be discounted for gift tax purposes. For example, you might give business interests valued at $1 million to your daughter. For gift tax purposes, these shares may be valued at only $600,000 to $800,000. That means you can use 4–8% less of your total lifetime gift tax exemption, while providing your daughter with a gift that will be worth considerably more in the future.

An Overlooked Strategy for Selling Your Business

Business owners typically sell their interests to partners, current management or perhaps a competitor. In rare cases, they may even take their company public. Another alternative is an employee stock ownership plan (ESOP). These plans offer employees the opportunity to become owners of the company for which they work by receiving shares of stock over the course of their careers. Employees do not pay for the stock and cannot buy it at a later date. Rather, stock is allocated to employees according to a formula that may be based on their relative compensation, seniority or a combination of characteristics.

Employees are typically vested in the stock they receive after five to seven years, but they cannot actually sell their holdings until they leave the company. At that time, if the company is privately owned, it is obligated to buy back the employee's shares at fair market value, based on annual, independent outside valuations.

An example can help to show how a transaction may work. Imagine that the tax basis in the business owner's company is $5 million. The owner is considering either an outright sale of the company or an ESOP, both of which have been valued at $30 million, meaning the business appreciated $25 million.

While there are many advantages to ESOPs (e.g., deferred capital gains taxes, the tax-deductible payment of debt principal and a "captive" buyer in your employees), there are also risks, such as expensive annual costs (e.g., lawyers, audits and trustees). Also, if you have a large number of employees who are older, you may face a large buy-back burden in a short period of time. In addition, S corporations are limited in taking advantage of deferring capital gains through investment in "qualified replacement property" as this is only available to C corporations.

When considering an ESOP, you will need to have a detailed discussion with your advisors so that pros and cons can be weighed. Clearly, this complex strategy takes time to implement — another reason you should begin your planning process years before your actual exit date. ■

Considering An Employee Stock Ownership Plan (ESOP)

SALE TO TRADITIONAL BUYER	SALE TO ESOP
Business owner may be able to pay 20% long-term federal capital gains tax on the appreciated value, or $5 million; reducing net-proceeds to $25 million.	Business owner can defer capital gains tax and receive the full net proceeds of $30 million, provided the following requirements are met:[2] • You must own the stock for at least three years and may not have received it from a qualified retirement plan or by exercising stock options. • After the sale, the ESOP must own at least 30% of the company. • The company must be organized as a C corporation at the time the ESOP purchases the stock. • You must reinvest the shares in what is called "qualified replacement property" within one year after the date of your sale. Qualified replacement property includes stocks, bonds, floating rate notes (FRNs) and a variety of other securities issued by U.S. corporations.

[2] Sec. 1042 of the Internal Revenue Code. Sales of stock to employee stock ownership plans or certain cooperatives.

For illustrative and educational purposes only. Clients should discuss their specific situation with their tax and legal advisors.

After the Transaction… …What Next?

Retirement? Your next business? Whatever your ambitions, take the time to decompress and continue working with your advisory team to finalize future plans. Specifically, you should consider updating your current wealth management strategy to reflect your new circumstances and objectives.

Your plan should address wealth transfer and taxation, as well as the following areas that are too often overlooked by owners who have recently sold their businesses:

Liability planning.
When the press announces the terms of the transaction and the assets involved, owners with large cash infusions often find themselves the target of litigation. Work with your attorney, accountant and Financial Advisor to develop strategies that can protect your wealth and mitigate the risks to your family's financial security.

Philanthropic planning.
Supporting charities and nonprofit organizations becomes far more complex when substantial assets are involved. Integrating philanthropic planning into your overall wealth management strategy can help you maximize the value of your gifts, reduce tax liability and provide a meaningful legacy to the institutions you support — without alienating family members who may not share your philanthropic values.

Investment policy formulation.
If your business offered a retirement plan, you're probably familiar with investment policy statements and the purpose they serve. A carefully drafted investment policy statement helps take emotions and impulses out of investment decisions and establishes criteria by which you can measure progress. Your Financial Advisor will help you create a statement that articulates objectives, cash flow and liquidity needs, risk tolerance and acceptable return ranges. Essentially, this document is a business plan for your personal finances. ■

The Transaction of a Lifetime

Exiting the business you've built and nurtured over the years is not a simple task — financially or emotionally. Whether you choose to transfer your business to family members or sell it to existing management or a third party, assiduous planning is critical, as is the support of an interdisciplinary team with the expertise to help you articulate and achieve your objectives.

Your Financial Advisor plays an important role in helping you develop and execute your succession planning strategy. He or she understands the interplay between decisions you make for your business and the impact they can have on your future financial security. To initiate a discussion, consult with your Financial Advisor and other potential advisory team members as far in advance of your proposed exit time frame as possible. ■

Your Financial Advisor plays an important role in helping you develop and execute your succession planning strategy.