



Maximize Your Wealth with a Winning Exit Plan

How To Get What You Want When You Leave Your Business

Few things are certain in business life, but there is one universal truth: Be it a carefully planned decision or the result of fate's swift hand, someday you will leave your business.

Your exit is going to take place in one of two ways:

1. You will transfer ownership of the business during your lifetime because you've decided you want out. Without planning, this will probably mean that you have to liquidate. With planning you will be able to sell the business to a third party, to key employees or co-workers, or to family members – all at minimal tax rates.
2. You will die or become totally disabled, and the business will have to be liquidated unless some type of business continuity arrangements have been planned and documented.

Most owners measure their satisfaction with their business in terms of the income, wealth, identity, challenge, stimulation, satisfaction and pride that it provides to them. Consider another definition of success that measures a business – not only by how well it operates under your ownership and by the benefits it provides -- but also by the rewards it will bestow when you leave it. Because in the end, what you really want and need from your business is the ability to leave it – under the most favorable conditions. The only way you as an owner can do this successfully is to create an exit plan as early as possible and stick to that plan as long as you maintain your business.

Developing Your Exit Plan

What exactly is an Exit Plan that will allow you to leave your business in style and how do you create it? Despite the almost infinite variety of businesses and business owners almost all exit plans contain common elements or goals. Generally these goals fall into three broad categories:

1. To create and preserve the value of the company;
2. To provide a means to exchange that value for money with the least tax consequence possible;
3. To meet personal and family needs by providing security and continuity to your business and for your family either upon your planned departure or if disaster strikes – upon your death or disability.

Creating and Preserving Value In Your Business

Most entrepreneurs are so dedicated to the worthy purpose of making money that they have little or no time to spend on creating and preserving value for their business. You must find the time because...

First, to exit the business in style, you will need cash. That source of cash is the business. To determine the amount of cash you will receive, we must know the value of the business.

Second, if you intend to give the business to children, the business must be valued and that value must be used for gift tax purposes.



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Third, the business typically comprises the great majority of an owner's total wealth. The IRS knows this just as surely as you do. Determining the value now, allows you the opportunity to design an Exit Plan taking your business into account with the goal of minimizing the IRS's take.

Fourth, well-designed key employee incentive compensation planning is central to increasing business value. Business value is often used as a measuring rod for such plans.

Fifth, if an owner goes through this exercise well before the business is sold or transferred, he or she will be able to pinpoint the factors that are crucial to measuring and increasing (or decreasing) the worth of the business.

How Much Is Your Business Worth?

Determining The Value

Valuation of your business is likely to be performed by your CPA or a business appraiser using a methodology consistent with the approaches sanctioned by the IRS. This valuation will determine a range of fair market values for your business for purposes of gifting, estate taxation, and general planning. Note that this fair market value is not the same as the sales price for your business. To determine the sales price, the fair market value is used as a hypothetical starting point and adjusted to accommodate factors like timing of the sale and industry cycles, current condition of the merger and acquisition market, interest rates, and geographic location among others.

The technical details of business valuation are beyond the scope of this report. But one aspect worth noting is that estimating the value of your business will be critically dependent on who the business will be transferred to. If you are selling the business to an outside third party, you will seek the highest possible value for your ownership interest. If you are transferring ownership to your children, you must make every effort to develop the lowest defensible value for your ownership interest. This counter intuitive strategy is due to the huge role the IRS plays in the transfer of your business.

If you decide to sell to an outside third party, it will be for cash and you'll want all you can get via a high value. But your children, your employees, your co-owner don't have much of that green stuff. Their source of money, or cash flow, is the same as yours – the business. They will need to earn money on the business and pay income tax on it (tax #1) then pay the balance to you to buy the business – at which time you will pay a second tax on the gain (tax #2). The higher the business value, the greater the purchase price. The greater the purchase price, the greater the double tax bite.

For example, if company earnings are distributed to the purchaser (let's say a key employee), it will be taxed to her as compensation – salary or bonus money. She will then pay the after tax money to you (say 65 cents of the original dollar of earnings). You in turn pay a capital gains tax on the 65 cents received (assume little or no basis on your ownership interest, therefore a tax of about 25 percent). The net is less than 50 cents on each dollar earned and paid out by the company.

In other words, all purchasers, other than outside third parties, need to look to the earnings of the company for money to pay to you because they have no money of their own. This results in a double tax paid on the money received by you (taxed once as the employee/purchaser earns it and once when you receive it for your stock). The higher the business value, the higher the tax, the more difficult it is to accomplish a successful transfer... the less likely you will leave your business in style. Methods for avoiding this double taxation are rather complex for our discussion here, but keep in mind



that determining the value of your business will require you to decide early on how you wish to transfer it.

How To Motivate And Retain Key Employees Through Ownership

The one indispensable component of a valuable business is its top employees. Think about it: your top employees are even more valuable than you are for the purpose of creating value for your ownership interest. The more valuable you are to the business, the less valuable the business will be when you leave it. What you need to do is leave behind key employees who add significant value to the business for several important reasons:

1. Properly motivated by a profit-based incentive plan, key employees do increase the value of your business.
2. Key employees often become potential owners when you decide to retire or move on to another venture.
3. If you decide to sell to a third party, the continued existence of a stable, motivated management team will increase the purchase price.

Key employees are not necessarily employees in key positions. Key employees think and act a lot like you, they are eager to be given responsibilities and challenges. Like you, they want to see the business grow and prosper, and they want to grow and prosper along with it. They take pride in being identified with, and contributing to, a successful business. In short, they act like owners. Their continued presence in the business is necessary if the business is to thrive.

There are several incentive packages you can implement to retain and motivate key employees. These incentive packages help your key employees reach their financial and psychological goals – if they stay with you. As your key employees attain their goals, the design of these incentive packages should also help you to achieve your ownership goal of building business value (and eventually converting that value into money). Take a hard look at your current employee benefit programs, especially those aimed at your key employees. Elements of your incentive program should include:

1. Financially attractive awards that create a potential bonus of at least 10 percent of the key employee's annual compensation. Anything less than this will not be sufficiently attractive to motivate the key employee to modify his or her performance to make the company more valuable.
2. Specifics; that is, determinable performance standards, such as the company reaching a certain net income or revenue level.
3. Structure to increase the company's value such that, as the key employee reaches measurable objective standards, the net income of the company increases.
4. Incentive reward vesting or "golden handcuffs" that link payment to tenure thus encouraging the employee to remain on the job in order to receive the reward.
5. Face-to-face meetings with your key employees to discuss the plan and make sure the incentive arrangements are thoroughly understood and all questions answered.

Four Ways To Leave Your Business – Which One Is Right For You?

Selecting your successor is a fundamental objective that is decided early in the Exit Planning process. Almost all owners want to transfer the business to other family members, an employee or a co-owner; only about 5 percent want to sell to an outside third party. Interestingly, however, most persons first identified as successors do not usually end up as the ultimate owners.



Choosing your successor involves a careful assessment of what you want from the sale of your business and who can best give it to you. There are only four ways to leave your business. If you know these methods and decide in advance which one you prefer, then you have a better chance of leaving your business under terms and conditions you choose. Without planning you are more likely to settle for terms and conditions beyond your control.

1. Transfer of Ownership to Your Children

50 percent of typical business owners want to transfer their business to their children. Fewer than one in three of these owners end up doing so. Because this is the riskiest way to leave your business, you must prepare for failure by developing a contingency plan to convey your business to another type of buyer.

Transferring a business within the family fulfills many people's personal goals of keeping their business and family together. It can provide financial well-being for younger family members unable to earn comparable income from outside employment, as well as allow you to stay actively involved in the business with your children until you choose your departure date. Transferring your business to your children will also afford you the luxury of selling the business for what you need to live on, even if the value of the business does not justify that sum of money. You will determine how much you need or want, rather than be told how much you will get.

On the other hand this option also holds great potential to increase family friction, discord, and feelings of unequal treatment among siblings. The normal objective of treating all children equally is difficult to achieve because one child will probably run or own the business at the perceived expense of the others. At the same time financial security is normally diminished rather than enhanced and the very existence of the business is at risk if it's transferred to a family member who can't or won't run it properly. In addition the vagaries of family dynamics may also significantly diminish your control over the business and its operations.

2. Sale to Other Owners or Employees

One of the great advantages of having other owners in your business is that they can be your means to retirement. Especially with smaller businesses, a common retirement planning technique is to have a younger individual buy into your business while you are still active. Upon your retirement, the younger owner will purchase your remaining stock.

This plan can be advantageous because the younger person learns the business – its structure, employees, customers, operation, and management – under your tutelage. More important for you, the younger person's capabilities (as well as his weaknesses) are known to you, so you have a pretty good idea of how your business will be run after you leave. And most important of all, the business can be sold to a market you create and control. You structure the deal ahead of time to suit your particular needs and objectives.

Disadvantages in this plan are that there is no cash up front, unless you as the owner have pre-funded the sale, but even then, you have probably pre-funded with money that was yours anyway. A great risk also exists in the fact that the buyout money comes from the future earnings of the business after you leave it. Employees are often employees because they don't have an owner "mindset." They're not entrepreneurs and they don't respond well to the challenges and pressures of ownership. These disadvantages apply especially to businesses worth more than \$2 million. The owner simply has too much money and financial independence at risk, and the price will be too high for an employee to afford.



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3. Sell It To A Third Party

In a retirement situation, a sale to a third party too often becomes a bargain sale – the only alternative to liquidation. But if the business is well prepared for sale this option just might be your best way to cash out. In fact you may find that this so called "last resort" strategy just happens to land you at the resort of your choice.

Although many owners don't realize it, you should get most or all of your money from the business at closing. Therefore, the fundamental advantage of a third party sale is immediate cash or at least a substantial up front portion of the selling price. This ensures that you obtain your fundamental objectives of financial security and, perhaps, avoid risk as well. A second unanticipated advantage in selling to a third party is the ability to frequently receive substantially more cash than your CPA or other business appraiser anticipated because the market place is "hot." Finally, this may be the best option for a business that is too valuable to be purchased by anyone other than someone who has access to a considerable source of money.

If you do not receive the bulk of the purchase price in cash, at closing, however, your risk will suddenly become immense. You will place a substantial amount of the money you counted on receiving in the unpredictable hands of fate. The best way to avoid this risk is to get all of the money you are going to need at closing. This way any outstanding balance payable to you is "icing on the cake."

4. Liquidate It

If there is no one to buy your business, you shut it down. In a liquidation the owners sell off their assets, collect outstanding accounts receivable, pay off their bills, and keep what's left, if anything, for themselves.

The primary reason liquidation is considered is that a business lacks sufficient income-producing capacity apart from the owner's direct efforts and apart from the value of the assets themselves. For example if the business can produce only \$75,000 per year and the assets themselves are worth \$1 million, no one would pay more for the business than the value of the assets.

Service businesses in particular are thought to have little value when the owner leaves the business. Since most service businesses have little "hard value" other than accounts receivable, liquidation produces the smallest return for the owner's lifelong commitment to the business. Smart owners guard against this. They plan ahead to ensure that they do not have to rely on this last ditch method to fund their retirement.