



# The Wealth Advisor

## Understanding Business Exit Planning in Today's Market

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Have you been looking forward to the day you can retire, perhaps turn your business over to a son or daughter, or sell it? Even if you are not planning to stop working, you need to plan for the day you cannot run your business due to unforeseen illness or death.

Most business owners do not take the time to plan for how they will leave their business. They are busy running the company, or they don't know where to start. But if you continue to own a business until you die, it will be included in your estate and could be subject to substantial estate taxes. Your family could be forced to sell the business or its assets at "fire sale" prices. Then you will have worked hard all these years so that the vultures and Uncle Sam, not your family, will reap the benefits.

Planning for how you will exit from your business should be an integral part of your estate and retirement planning. Proper planning now can provide you with retirement income, reduced income and estate taxes, and even let you benefit a charity if you so choose, regardless of whether you transfer your business to family members at discounted values, to employees, or to an outside buyer.

In today's market, the economy and trends are affecting the timing and value of business transfers. In this issue of *The Wealth Advisor*, we will look at some of the conditions that make this market different, things you can start doing now to make the transfer process go smoothly, and provide some insight into how to make a business transfer work for all of those involved.

### Today's Climate for Business Transfers

Let's look briefly at the various influences that are making today's market different.

*Demographics:* The first wave of baby boomers applied for Social Security in January 2009. As more move into retirement, what will happen to their businesses? Due to the sheer numbers of this aging population, there may be two to three sellers for every qualified buyer. This increased competition will affect the values of their businesses.

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**Regulation Environment:** Regulations on the financial markets continue to increase, affecting commercial and investment banks, insurance companies, broker-dealers, CPAs and valuers of all types. More regulation means fewer options for transfers.

**Economic Environment:** Generally speaking, since 1960 we have had a recession at the turn of each decade. During previous recessions, owners invested in their business, trimmed expenses, laid off employees - whatever it took to keep the business going. They did this knowing that when the recession ended, they would recover and make a return on their investment. That may not work this time. Many businesses may not survive and recover because the length and depth of a recession is dependent on current government policies - spending, tax and regulation. With this recession, we have added spending (war, stimulus, health care, entitlement programs, etc.); additional taxes (income, gift, estate) and additional regulation (OSHA, EPA, etc).

**Corporate Finance Environment:** Outside financing is difficult these days. Typically a buyer might provide 40% cash, 40% from lenders and 20% to be paid over time. There will be less available from lenders until the capital markets recover from the downturn that started in 2007.

**Taxation Environment:** Taxation on business owners is increasing. If the Bush-era tax cuts are allowed to expire, income taxes will increase to 39.6%, long-term capital gains tax will increase from 15% to 20-28%, the estate tax will go back to a \$1 million exemption, and a 55% top bracket rate and the annual gift tax exclusion will be back to \$10,000. Plus Congress is looking at a first-time Medicare tax on passive income and enacted a 3.8% health care surtax on higher incomes earlier this year. In addition, business valuation discounts, popular with family limited partnerships and LLCs, are under attack in Congress.

**What You Can Do To Prepare and Make the Transfer Process Go Smoothly**  
Most owners simply cannot wait until they reach age 68 and then decide to sell. In most cases, it takes time to prepare to go to market. Even in this climate, there are things you can do as a business owner to protect or increase the value of your business in anticipation of a transfer.

#### *Cut Taxes and Expenses*

Most private companies are "S" corporations and almost all of them pass an income tax burden to their owners. Therefore most business owners are already obsessed with minimizing or eliminating income taxes. But for the first time, we are looking at individual tax rates that will be higher than corporate rates; and the dividend tax rate is also increasing. Look at your business structure to see if you can find ways to reduce taxes. Also, take a closer look at your expenses. Are you doing things that are causing the value to go up or down? Are there personal expenses that should not be run through the business? Keeping cash flow in the business will allow for growth or can be used to support the transfer you desire.

#### *Evaluate Management and Employees*

Do you have the best people in the right jobs? Frequently family members are brought in as management. If they are not the best choice for the position, it can

negatively affect the growth and potential value of your company.

#### *Be Clear and Honest About Your Goals and Objectives*

Most business owners have four goals when they leave their businesses: retire from the business; sell to a new owner (family members, employees or a third party); minimize taxes; and maximize profits. Some would also like to do good things for their community or favorite charity. Being clear about your motives and desires will make the planning process easier, saving you time and money.

#### *Be Realistic About the Value of Your Company*

Frequently there is a gap between what the owner thinks the company is worth and the actual fair market value. In both good and bad economic times, an appropriate multiple for most U.S. businesses (those with annual sales of \$5 million or less) is two to three times annual sales. Expect to get a lower multiple (one to one and a half) for a company that would not survive without the owner continuing to work in it, and a slightly higher multiple for one that is strong without the owner's participation.

#### *Be Realistic About Your Role After the Transfer*

It is not unusual for the owner and the recipient to have different objectives. Things will go much more smoothly if you understand what motivates each of you. Here are examples to consider.

#### ***Family Transfer***

The owner may want to transfer ownership of the business to the children now or after his death, maintain his current lifestyle, treat the children equally and fairly and, most of all, keep control.

The buying children will want to grow the business, try new ideas and take risks. They are willing to pay a fair price for the company, and will want a clear path and plan for the change of control. They are willing to work for a below-market wage for a while, but eventually they want to be able to compensate themselves for their efforts. They want to treat their siblings equitably but not have them share in the growth forever, especially if they do not work in the business. And they are willing to pay their parents a reasonable salary for a time, as long as they are contributing to the growth of the business.

**Planning Tip:** You may be able to continue doing what you love in the business, especially if it will contribute to the bottom line. Consider providing for your nonworking children through other planning, for example, life insurance.

#### ***Management/Employee Transfer***

Usually the seller is not as comfortable transferring the business to management or employees as he or she would be with transferring the business to family members. The seller may want to remain in control until death or retirement, or at least until paid in full. The seller may want to make sure the legacy lives on and may even want restrictions on the transfer so the seller can take the company back if unhappy with the direction it is going. The seller will usually want to maintain his or her current lifestyle and may want a significant cash payment at closing, but does not want to personally guarantee the loan.

Management's objectives are very similar to those of the second generation in a family transfer. They will want to grow the business, try new ideas, and take risks. They are willing to pay a fair price for the company, and want a clear path and plan for change in control. They are willing to work for a below-market wage for a while, but eventually be able to compensate themselves for their efforts. And they are willing to pay the seller a reasonable salary for a time, as long as he or she is contributing to the growth of the business.

**Planning Tip:** You may want to contribute to the company in an area in which you excel; for example, spending time in sales or training a sales force. Also, you may have to guarantee a loan for a period of time, especially if you still have some control.

### *Select Experienced Advisors*

A successful business exit plan requires an experienced team of advisors, which can include an attorney, CPA, financial advisor, insurance agent and valuation expert. These advisors will review your situation and recommend the best strategy to accomplish your objectives. It is critical that you understand the plan, why you are doing it, any potential risks, how the transfer will occur, and who is responsible for each step. Whether your business transfer will involve a family limited partnership, a buy/sell arrangement, charitable trusts, employee stock ownership plan, or a private sale will depend on your situation, goals and desires.

### *Don't Procrastinate*

Your final job is to follow through and implement the plan.

### **Conclusion**

Planning now to exit your company will result in you and your family receiving the best possible results, both now and after your retirement, disability or death. You can receive retirement income; you can transfer your business to your family, your employees or an outside buyer; you can make a difference for a charity or your community; and you can do all of this with reduced income, gift and estate taxes. You just have to get started now. We can help you do that.

In future issues of *The Wealth Advisor*, we will look at some of the strategies that can be used in business transition planning. In the meantime, please contact our office if you have any questions.

### **Test Your Knowledge With This True or False Quiz**

1. In today's market, there could be two to three sellers for every qualified buyer. **True or False**
2. Proper planning can provide you with retirement income, reduced income and estate taxes, and even let you benefit a charity. **True or False**
3. There will be less money available from lenders until the capital markets recover from the downturn that started in 2007. **True or False**
4. More regulations on the financial market mean fewer options for transfers. **True**

or **False**

5. Taxation on business owners will increase if the Bush-era tax cuts expire. **True** or **False**

6. There is often a gap between what the owner thinks his company is worth and the actual fair market value. **True** or **False**

7. Most business owners are happy to transfer control of the family business to the next generation and just walk away. **True** or **False**

8. Most business owners don't take the time to do this planning because they are busy running the company or don't know where to start. **True** or **False**

9. Most owners can still wait until they are ready to retire to start thinking about transferring their business. **True** or **False**

10. A successful business transfer plan requires an experienced team of advisors, which can include an attorney, CPA, financial advisor, insurance agent and valuation expert. **True** or **False**

*Answers: 7 and 9 are false; the rest are true.*

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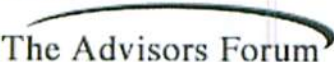
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