THE WEALTH COUNSELOR

MONTHLY NEWSLETTER

Understanding Business Transition Strategies

From Daniel Capobianco

Law Offices of Daniel Capobianco

101 Arch Street
Suite 900
Boston, MA 02110
617-261-5355

The Law Offices of Daniel B. Capobianco specializes in all areas of domestic and international taxation with emphasis on complex integrated estate plans with multiple tax strategies, charitable tax planning and business succession planning.

For our clients who own a business, planning for the transfer of the business is always be built into our estate planning process. An integrated approach in dealing with retirement and estate planning is particularly needed for these clients.

We help these clients understand the transfer options that are available, and help them determine what is best for them and how it will affect their families, their employees and others. We do it in a way that takes into consideration the current economic times, availability of financing, financial and non-financial issues, and how these transactions take place. We help them through the process so that, rather than just taking a salary for life, they execute and implement the comprehensive plan that we develop with and present to them.

Demographics/Competition
The first wave of Baby Boomers applied for Social Security in January 2009. As more of them move closer to 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, coupled with the 2008 stock market crash, will affect business valuations.

Regulatory Environment
Regulations on the financial market continue to increase, affecting banks, investment houses, insurance companies, broker dealers, CPAs and valuators 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 (stimulus, health care and deficits); additional taxes (income, gift, estate); and additional regulation (OSHA, EPA, etc.).

Corporate Finance Environment
Outside financing is more difficult these days. Typically a buyer might provide 40% in cash, 40% from lenders and 20% equity. 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 with the Bush-era tax cuts expiring. Income taxes are going to 39.6% (higher with the 3.8% health care tax on higher incomes). We are looking at a first-time Medicare tax on passive income. Long-term capital gains tax is increasing from 15% to 20-28%. If Congress does not act, the estate tax will go back to a $1 million exemption and 55% tax rate. The annual gift tax exclusion will be back to $10,000, and business valuation discounts, popular with family limited partnerships and LLCs, are under attack in Congress.

Some Key Differences Between Public and Private Companies *Income Tax*

Public company CEOs generally do not worry about the amount or rate of income taxation because those costs will be passed on to the consumer. Most private companies are “S” corporations and almost all of them pass an income tax burden to their owners, so the owner of a private company is obsessed with minimizing or eliminating income taxes.

Planning Tip: *For the first time, individual tax rates will be higher than corporate rates; the dividend tax rate is also increasing. Look at the business structure to find ways to reduce taxes and keep cash flow in the business to allow for growth or to make the desired transfer*.

Growth

The CEO of a public company seeks to grow share value; its board of directors will act quickly to remove and replace non-performing management. The owner of a private company seeks to grow family wealth, starting with himself, and has often invested personal assets to start the business or keep it going. The board of directors (if any) is reluctant to make changes to management, who are often family members. If they are not the best choice for the job, that can negatively affect the growth of the company.

Access to Capital

The CFO of a public company strives to obtain capital at the lowest possible cost. The owner of a privately held business has very limited access to capital. He will take what he can get, usually requiring a personal guarantee.

Value

A privately held business has multiple values on the same day, which can be obtained appropriately, legally and accurately, depending on the owner’s motives and direction of the transfer. These values include synergistic (competitor wants to acquire the business for integration or to reduce costs); market value; control value (Rev. Rule 59-60, 26CFR 2510-13); minority value (Rev. Rule 59-60); non-voting, minority value (Rev. Rule 59-60); liquidation value, forced or orderly. Frequently there is a “value expectation gap” between what the owner thinks the company is worth and the actual fair market value.

Planning Tip: *The economy, market and trends affect the timing and value of transfers. Most owners cannot wait until they reach age 68 and then decide to sell. Therefore, it is often necessary to prepare your Business to go to market. Is the owner doing things that are causing the value to go up or down? Perhaps there are personal expenses that should not be run through the business.*

Private Capital Markets

5.4 million U.S. businesses have sales of $5 million or less compared to 300,000 that have sales from $5 million to $1 billion and only 2,000 that have sales over $1 billion. Thus the vast majority of the businesses we work with have sales of $5 million or less. In both good and bad economic times, an appropriate multiple on the open market for this size company is 2-3 times annual sales. Expect to get a lower multiple (1-1.5) 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.

Business Transfer Spectrum/Uncovering the Client's Transfer Motive *Transfer Channels*
There are a variety of channels through which the transfer can occur. For example, transfers can be made internally-to family members, co-owners, charitable trusts and employees-or externally through auctions and public offerings. The transfer methods to be used can then be determined based on the client's motives.

Family: Gifts; SCINs; Annuities; GRATs; FLPs; IDGTs

Co-Owners: Buy/Sell Agreements (containing a variety of valuation and/or purchase options)

Charitable Trusts: CRATs; CRUTs; CLATs; CLUTs

Employees: ESOPS; Management Buyout/Ins; Options; Phantom Stock; Stock Appreciation Rights

Outside (Retire): Negotiated One-Step Private Auctions; Two-Step Public Auctions

Outside (Continue): Consolidated Roll-ups; Buy and Build Recaps

Public: Initial Public Offerings; Direct Public Offerings; Reverse Mergers; Going Private

We often go through an "Options Analysis" as an initial phase with our clients. We include valuations using various options (products used; strengths and weaknesses). It's much better to uncover a client's motives early on before we spend too much time with one option only to find out our client actually thinks differently.

How to Make the Transfer Work for Everyone
Quite frequently, the owner and the recipient of the transfer will have different objectives. Here are some examples.

Family Transfer

Objectives of Legacy Generation (Owner)
He or she will want to transfer ownership to the children now or after death, maintain his or her current lifestyle, treat the children equally and fairly and, most of all, remain in control.

Objectives of Second Generation
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. They want to treat 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 the parents a reasonable salary for a time, as long as they are contributing to the growth of the business.

Management/Employee Transfer

Seller's Objectives
In situations where our clients desire to transfer the business to management or employees, there are often mechanisms for retention of control until death or retirement, or at least until payment in full from the buyer. There could also be restrictions on the transfer of the business so that the owner can take the company back if he/she is not happy with the direction it is going. Maintaining current lifestyle may dictate a significant cash payment at closing, placing risk of failure upon the buyer.

Management's Objectives
These 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 is contributing to the growth of the business.

Planning Tip: *The original owner may want to contribute to the company in an area in which he excels; for example, spending time in sales or training a sales force. Also, the seller may have to guarantee a loan for a period of time, especially if he still has some control.*

Third Party Transfer
Sometimes the owner needs an infusion of capital to expand the business, and may want to participate in the resulting upside. Often the seller wants a significant check at closing (70-80%) in exchange for giving up operating control. Would the seller want to be involved with a small stake in the business but little control? Could the seller become a team player with someone else calling the shots? The seller may not want to stay, but prefer to retire or remain on the board of directors. If family members are involved in the business, they can be compensated/rewarded with proceeds from personal estate planning.

Planning Tip: *The choice of entity will affect the valuation of a private company, and therefore, the controlling document (bylaws, operating agreement, partnership agreement) is a main focus of our planning. Generally, the greater the restrictions, the greater the impact on the value.*

Planning Tip: *Why wouldn't the owner just stay on the payroll until he dies? He could, but such retention of benefits could adversely impact the company's value, and could result in adverse estate tax consequences. Planning now to transfer the company will result in the owner receiving the best possible results, both now and after his death.*

Conclusion
We should always be aware of the planning opportunities and needs where a privately owned company constitutes a large portion of one's estate. The transfer of the company will need to be incorporated into any retirement, family, estate and/or income tax planning.

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