LOYOLA UNIVERSITY
COLLEGE OF LAW

2016 ANNUAL ESTATE PLANNING CONFERENCE

DECEMBER 1 & 2, 2016

EXIT STRATEGIES AND CONSIDERATIONS FOR BUSINESS OWNERS

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I. <u>INTRODUCTION</u>

Patrick A. Ungashick has written an excellent book entitled "Dance in The End Zone: The Business Owner's Exit Planning Playbook," which derives its title from that famous moment when Elmo Wright (a wide receiver for the Kansas City Chiefs) scored a touchdown on November 8, 1973 against the Houston Oilers and celebrated by dancing in the End Zone, celebrating his success and accomplishment. ***What happened in the End Zone that day defined Elmo Wright's life and career.***

Similarly, most Business Owner's invest decades of sweat, risk and sacrifice into their businesses and what happens when they exit their business (i.e., when they reach their End Zone) likewise also defines their lives and careers. An Exit that falls short can mean financial disappointment, family strife, loss of self-esteem and despair rather than the crowning achievement of a career emanating in the fulfillment of financial dreams and the leaving of a successful legacy.

The purpose of Patrick Ungashick's book, "Dance in the End Zone" and today's presentation is to offer you practical, understandable, and applicable suggestions and tools to assist closely-held Business Owners (including yourselves) who desire to Dance in the End Zone.

Although they may disagree with me, those entrepreneurial founders and creators of closely-held businesses will not live forever and cannot effectively rule from the grave, so they might as well put as much effort into passing on their visions of a business legacy as they exert in creating their businesses.

<u>**THE FIVE YEARS' FALLACY: TIMING THE EXIT**</u>

The Owner knows ideally when he/she wants to Exit from the Business, which is when the Owner is_________ years old or _________ years from now.

Although Business Owners may think they know the age or year in which they may wish to exit, successfully exiting a business depends both on an internal and external environment. You just can't say: "I will exit in five years or when I am 60 years old. There are at least four (4) flaws in timing an Exit strategy.

<u>**Flaw 1**</u>: Certain tactics may take longer to implement than the target period, including the following:

(A) Matching up your Exit Plan with the appropriate business entity may require years to implement; for example, eliminating the built-in gains tax on the conversion from C Corporation to S Corporation status. An S Corporation which has converted from subchapter C status within the past five years can be subject to substantial built-in-gain (BIG) taxes upon a sale, which BIG taxes are imposed at the highest corporate rate, resulting in double taxation on an asset sale, first at the corporate level and then at the individual level upon liquidation of the corporation.

(B) The trajectory of the business may be too steep to implement a gift planning strategy using $14,000/year annual exclusion gifts. *(See July 15, 2016 Lukinovich Lagniappe Newsletter entitled "Sale to Defective Grantor Trusts [Case Study for Olive and Earl Breaux attached as Exhibit "A"]")* for a sample leveraging strategy using sales to a Multigenerational Grantor Trust.

(C) Time restraints may exist on tying down registration and ownership of intellectual property on sale to a third-party buyer.

(D) Development of a capable management team of lieutenants to run the business after founder's departure.

Flaw 2: Availability of capital markets, interest rates, industry's health and other external uncontrollable factors may affect timing of Exit. Thus, leaving only a few years of preparation time may limit the ability to achieve the most favorable external climate. **Example**: Our firm was in the process of selling an oil and gas service company when oil prices plummeted; this unexpected external event shut down the sale and resulted in a workout of the company due to leveraging up pre-sale.

Flaw 3: Inability to predict the future, a prospective strategic or emotional buyer may show up, and you may not be ready to effect the Exit. What about an untimely (never a good time) death or disability of the founder or a key person?

Flaw 4: You cannot implement an Exit Planning Strategy without a clear vision of where you need to wind up. You must begin with the "end in mind" as Stephen Covey would say. Thus, you should align your Business Growth Plan with your Business Exit Plan. (**Example**: Client in process of shifting a division into a new company through a corporate spinoff).

Summary: Do not confuse Exit Planning with Business Succession Planning. Succession Planning focuses on meeting the needs of the Business; Exit Planning aims at meeting the needs of the Business Owner. *(See April 15, 2015 Lukinovich Lagniappe Newsletter entitled "Business Successions and Exit Planning Strategies" for a comparison of Business Succession Planning versus Exit Planning attached as Exhibit "B").*

Why does a homeowner spend 20 years living in a home with no ongoing maintenance then fix everything up to sell to a prospective purchaser instead of maintaining and enjoying the house all 20 years and always being prepared for a potential purchaser to knock on the door? Similarly, if a Business Owner has his house in order, not only will he or she be prepared for an Exit, the annual profits of the business and enjoyment of the workplace environment will be enhanced.

Several essential End Zone Questions:

(1) When do you want to exit?

(2) What is your likely exit strategy?

(3) How much is your Exit Magic Number calculation?

(4) Where will it come from?

(5) What risks do you face prior to exit?

(6) What will you do in life after exit?

(7) Who is your exit planning team?

In preparing for Exit, the Owner(s) and family members and business partners may benefit from the following excellent books and encyclicals:

(1) **The Ultimate Gift**, by Jim Stovall

(2) **Think and Grow Rich**, by Napoleon Hill

(3) **How to Win Friends and Influence People**, by Dale Carnegie

(4) **From $uccess To Significance** (When the pursuit of success isn’t enough), by Lloyd Reeb

(5) **Finishing Well** (What people who REALLY live do differently!), by Bob Buford

(6) **God Wants You to Be Rich** (How and why everyone can enjoy material and spiritual wealth in our abundant world), by Paul Zane Pilzer

(7) **The 7 Habits of Highly Effective People** (Powerful lessons in personal change), by Stephen R. Covey

(8) **Preparing Heirs** (Five steps to a successful transition of family wealth and values), by Roy Williams and Vic Preisser

(9) **Family Wealth – Keeping it in The Family** (How family members *and* their advisers preserve Human, Intellectual, and Financial assets *for* generations), by James E. Hughes, Jr.

(10) **The Power of Focus** (How to hit your business, personal and financial targets with confidence and certainty), by Jack Canfield, Mark Victor Hansen and Les Hewitt

(11) **Today Matters** (12 daily practices to guarantee tomorrow's success), by John C. Maxwell

(12) **Encyclicals "Rerun Novarum" (May 15, 1891),** by Pope Leo XIII and "**Centesimus Annus" (May 1, 1991)**, by Pope John Paul II on the hundredth anniversary of Rerum Novarum

Of the four ways to Exit from a Business (pass it to family members, sell it to outsiders, sell it to employees of the Business, or an orderly liquidation), the Owner should clearly be determined which method is ideal. Patrick Ungashick develops his football imagery by referring to the four (4) Exit Strategies as:

(1) The Passer's Game Plan;

(2) The Outie's Game Plan;

(3) The Innie's Game Plan; and

(4) The Squeezer's Game Plan.

II. THE PASSER'S GAME

The **Passer's Game Plan** is to implement a smooth transfer of the business to a successor family member of members. Most Passer's are not concerned about getting "Maximum Value" for their business; but, in situations where the Passer does not want to give his family member(s) a "sweetheart deal" and desires to avoid any kind of "silver spoon" sales price, the Exit Plan might closely resemble that of an "Innie," or sale to an insider key employee(s) that just happens to be a family members(s). The most important issues Passers may face include:

1. Creating financial freedom for the Passer;
2. Transferring control in an orderly manner;
3. Transferring ownership in an orderly manner;
4. Treating all heirs fairly (not necessarily equally); and
5. Insuring adequate estate liquidity.

ISSUE ONE FOR THE PASSER: Creating financial freedom for the Passer.

This issue is doubly important for the Passer, especially if the Passer is financially dependent on the business. The Passer must properly ascertain the most realistic value of the business and structure a payment plan that achieves receiving that value which meets the expectations of both the Passer and family member(s) to preserve family harmony.

A. Playbook: Employment Contract

To provide the Purchaser some deductibility and to enable the Passer to maintain some benefits of the business, the Passer may enter into an Employment Contract separate from the Sales Agreement.

<u>Benefit</u>: The business may deduct reasonable compensation and the benefits paid to the Passer such as medical insurance, company car, entertainment (within limits), etc.

<u>Burden</u>: The Passer is taxed on earnings at ordinary income tax rates and is subject to payroll taxes.

<u>Key</u>: Be sure to establish the length of employment to manage everyone's expectations and define roles and responsibilities so buying family member(s) clearly controls and manages the business but the Passer stays as relevant as possible.

B. Playbook: Consulting Company *(variation from Employment Contract)*

The Passer may wish to enter into a consulting contract to provide specified services to the business and similar services to other unrelated businesses to remain relevant and stay engaged.

<u>Benefits</u>: The Passer can evaluate and implement a tax-deductible retirement plan inside the consulting company to shelter earnings from income taxes (deferred and possibly asset protected) and, if a C Corporation, create employee benefits such as medical insurance or private long-term care insurance in a tax favorable manner.

<u>Burdens:</u> Passer cannot access company benefits of former business and earnings are subject to ordinary income tax and self-employment taxes.

C. Playbook: Salary Continuation Plan

A Salary Continuation Plan is a formal written compensation agreement to continue the reasonable salary of a key employee after termination of service.

<u>Benefits:</u> The inclusion of a Salary Continuation Plan may assist the Purchasing family members by reducing the purchase price and cash flow obligations in purchasing the business and at the same time reduce the value of the business to the Passer for estate and gift tax purposes by booking a company liability at the time of the Exit and does not require the Passer to continue working so that the benefit is payable beyond death or disability and can pass on to a surviving spouse.

Burdens: The Passer retains no access to Company benefits and the earnings are still subject to ordinary income taxes and self-employment payroll taxes.

Key: Implementing a Salary Continuation Agreement shortly before the Passer's Exit may undermine the ability to demonstrate the business purpose of the Agreement.

D. Playbook: Lost Wages

Lost wages are payments to an employee to make up for a period of below market compensation; these can be considered for payment at the time of the Exit and have similar burdens and benefits as a Salary Continuation payment.

Key: To support the "lost wage payment," a compensation study should be commissioned from a qualified expert or company.

ISSUE TWO: Transferring Control in An Orderly Manner

Transferring control and transferring ownership are two completely separate and distinct issues. For many Owners, control of the business is the linchpin to their financial, emotional, and psychological security. In a study, **98%** of Business Owners identified "desire to control their lives" or "captain their own ships" as an important benefit of being a Business Owner, although only **3%** in the same survey agreed that "becoming wealthy" was an important motivation.

Consideration: Our firm often recommends recapitalizing the business into voting and non-voting equity (i.e., stock if a corporation or membership interests/units if a limited liability company), for example, 1% voting and 99% voting, so that the Owner can sell or donate non-voting interests while at the same time retain control until the Owner is ready to relinquish and "let go" of control.

E. Playbook: Family Development Budget

Although businesses have budgets for increasing sales, developing new products or services, improving operations, training employees, etc., the Passers of those businesses rarely establish a Family Development Budget to prepare their family member(s) to take over the business successfully.

Suggestion: The Passer should establish a Family Development Budget and notify all appropriate members that this issue will be taken seriously and supported with development resources including workshops, books, family business organizations and outside consultants to enhance the success of the future Business Ownership transaction.

F. Playbook: Control Checkpoints

The Passer and his/her designated family member(s) should carefully chart out a game plan to transfer control which would include establishing Control Checkpoints where (a) responsibilities are assigned to the family member(s), (b) progress is evaluated, and (c) additional control is transferred only when the checkpoints are fully met.

Recommendations: The Passer should consider the following:

(1) Diagram with the family member(s) the business organizational chart as it is today and how it will evolve as control is transferred and use the chart to discuss the Passer's roles today and in the future.

(2) In collaboration with the family member(s), delineate job descriptions and set clear performance expectations as those duties

are transferred, as well as how the transfer of control will be affected if performance falls short of such expectations.

(3) Perform a strengths and weaknesses analysis of the family member(s) and identify a development plan for building on strengths and improving weaknesses.

(4) Write down the Control Checkpoints and meet frequently to measure progress and address areas that need further attention.

G. Playbook: Family Business Council

Establish a Family Business Council as a forum for the family to meet and discuss items scheduled with an agenda on a regular basis and include:

(1) Calendar of Scheduled Meetings (3 to 6 times per year).

(2) Formulate By-laws and Corporate Governance procedures.

(3) Invite relevant family members (those actively working in the businesses and those not but who are impacted by business's performance).

(4) Include when appropriate a professional meeting facilitator or coach to establish an Exiting Plan Team to participate in family meetings.

ISSUE THREE: **Transferring ownership in an Orderly Manner**

There are two ways for a Passer to transfer ownership: either by sale or donation, including multiple variations or combinations of those two methods. Transferring ownership by gift or donations usually avoids triggering income or capital gains taxes; however, gifts potentially can trigger gift and estate taxes when made beyond the annual gift tax exclusion (currently, $14,000 per year per donor/per donee) and the lifetime federal estate tax exemption and federal generation-skipping tax exemption (currently $5,450,000 each for the Passer, and the Passer's spouse, if any).

Consideration: If a business is growing by leaps and bounds, the Passer should consider donating Business Ownership interests sooner rather than later (i.e., leveraging) and, as previously mentioned, this can be accomplished with Non-Voting Equity so that ownership is transferred but control is not.

H. Playbook: Devalue the Business Then Give It Away

Often, to accommodate the Passer's desire to retain control, businesses are recapitalized to create a small portion of Voting Equity Interests and a much larger portion of Non-Voting Equity Interests and the Non-Voting Equity Interests are sold or donated either outright to family members or placed in trust if appropriate to postpone control of the transferred interests until the intended recipients attain a targeted age or level of maturity and responsibility.

Discount By-Product: A by-product of transferring Non-Voting Equity Interests is the devaluation of such interests by valuation discounts which include:

(1) Discounts for "**Lack of Control**" or minority ownership, which considers a diminution in value because the transferred interest does not represent a majority/decision-making block;

(2) Discounts for "**Lack of Marketability**," a reduction in value because the transferred interest is in a business that cannot be sold readily through an available market such as the stock exchange; and

(3) Several other discounts can be articulated and considered by qualified valuation experts in determining the appropriate value under the federal estate and gift tax laws. **Caveat**: Proposed Regulations to Eliminate Family Discounts.

I. Playbook: Parallel Business

One way of shifting value from the Passer to the family member(s) who will succeed to the family business is creating a parallel business owned mostly or entirely by the family member(s) and migrating business activities and opportunities over time to the parallel or "new business entity." We sometimes refer to this strategy as Old Co./New Co.

Benefits: Acceleration in transfer of value without estate/gift taxation downstream to the succeeding family member(s).

Burdens: Often times, this strategy takes many years to implement, must be coordinated with customers, operating employees, bankers, etc. and increases overhead costs and administrative workload.

Key: Careful planning with the Passer's Exit Team is essential.

Planning: To effectively transfer a large and/or fast growing business without federal estate or gift taxation, a computation of sales/donations should be considered along with a combination of the leveraging strategies discussed below.

J. Playbook: Grantor Retained Annuity Trust (GRATs)

A GRAT strategy can be employed by a Passer to sell a business to the succeeding family member(s) income tax free in exchange for an income stream payable to the Passer over a designated period of time selected by the parties and funded through distributed business profits generated during the GRAT term after the GRAT is implemented. The benefits and burdens of a GRAT strategy and a comparison of GRAT strategies and Multigenerational Defective Grantor Trust strategies (IDGTs) is outlined in the *Lukinovich Lagniappe Newsletter entitled "Grantor Trust Strategies in Estate Planning" dated July 2015*, attached as Exhibit "C".

K. Playbook: Intentionally Defective Grantor Trust (IDGTs)

Although an IDGT is similar in many ways to a GRAT, the IDGT can be employed on a multi-generational basis using short term (0 to 3 years), mid-term (3+ years to 9 years) or long-term (over 9 years) IRS Applicable Federal Rates (currently at all time low interest rates) and does not require the Passer to survive the payment term in order to realize the tax and economic benefits.

ISSUE FOUR: Treating all of your heirs fairly.

Being fair in the distribution of assets to the Passer's heirs rarely results in an equal distribution of assets among descending family lines. The more concentrated the Passer's wealth is inside of the Passer's closely-held business, the more difficult it is in achieving "fairness."

Starting Point: In order to determine what is fair, the advisors must encourage the Passer to articulate what the Passer believes will be "fair" considering all of the Passer's assets and resources. Advisors cannot just accept a "share and share alike" approach and join at the hip both family members who work in the family business and those who don't without careful thought. Likewise, the Passer will not be fair if he has 3 children, donates or sells a $10 million business to Child A who is active in the business and funds life insurance that provides $10 million of death benefit proceeds to each of Child B and Child C who have to do nothing to enjoy the benefit of this benevolence.

Extraordinary Unique Solution: One family who we worked with determined that fair to their four (4) extremely talented and well educated children should be obtained by the following:

(1) Utilizing professional outside management including a board of directors including the four children and several outside independent directors to manage the primary

family business and related real estate (collectively, the "Golden Goose"). *(See Lukinovich Lagniappe Newsletter entitled "Using Independent Outside Directors to Supplement/Complement Family Directors in Family Owned Business Enterprises, dated April 2016 attached as Exhibit "D").*

(2) Distributing outright to the four (4) children and in Multi-Generational Trusts for the four (4) children and their current and future descendants' equity interests in the "golden goose," so that distributions (in excess of cash needed to pay taxes) could be made to the four (4) children to allow each of them to locate and acquire their own closely-held businesses.

(3) Establishing a Family Business Council with family members and professional advisors and holding scheduled meetings and retreats to discuss Human Capital in addition to Financial Capital. An excellent book on the different types of Capital is James E. Hughes, Jr.'s "Family Wealth – Keeping It in the Family."

L. Playbook: Family Balancer Trust

One often used balancing mechanism to implement a Passer's goal of "fairness" among family members is to create an irrevocable life insurance trust to fund with life insurance on the Passer (and the Passer's spouse if appropriate) to complement the business assets transferred to the family member(s) succeeding to the Passer's business(es).

M. Playbook: Asset Lease Backs to Non-Working Family Members

Alternatively, Passers may consider donating or selling real estate and other assets used in a business to non-working family members so those assets can be leased back to the business sold or donated to the working family member(s). This creates an income stream from the business to the non-working family members without sharing actual ownership or control of the business.

> **<u>Key</u>**: The Leases should be written, contain appropriate extension clauses and fair rental lease payments and include a mechanism for adjusting rental rates in the future as the business expands or contracts when any external economic and other factors come into play.

N. Playbook: Non-Voting Equity Interests for Inactive Family Members

When appropriate, especially when the Passer's business comprises a substantial portion of the Passer's wealth, a recapitalization of the business with Voting and Non-Voting Equity Interests can enable the Passer to transfer Voting Equity Interests and control to a family member(s) active in the business and Non-Voting Equity Interests to family member(s) not active in the business.

> **<u>Key:</u>** Consideration should be given to providing the active family member(s) a "call option" and the inactive family member(s) a "put option" at a purchase price determined by an appropriate valuation method or pursuant to an independent qualified appraisal using an appropriate valuation methodology in the event the family members find they cannot co-exist harmoniously. Of course, other corporate governance requirements will need to be incorporated to preserve business relations among family members with required minimum distributions for tax payments and quality of life distributions needed commensurate with a fair return on assets and preventing abusive or excessive bonuses or benefits to active family members.

<u>ISSUE FIVE:</u> Insuring Adequate Estate Liquidity.

Insufficient liquidity or access to liquidity within 9 months of the death of an Owner could result in catastrophic losses in business value or in the business itself, such as the loss of the Miami Dolphins and stadium on the death of Joe Robbie. Although there are special tax provisions to mitigate the payment of estate taxes when an Owner's estate includes a business that comprises a large percentage of the Owner's assets, relying on estate tax deferral payments should only be a contingency plan when life insurance or other liquidity funding mechanisms are unavailable to keep up with the growth of the business.

O. Playbook: Irrevocable Life Insurance Trust

Irrevocable Life Insurance trusts owning life insurance on the Business Owner (and Business Owner's spouse if appropriate) are often used to satisfy liquidity needs in estate planning.

<u>Key:</u> Ownership and beneficiary designations should be reviewed by the Owner and the Exit Plan Team to confirm no unintended consequences that would thwart the Owner's Exit Plan objectives. (**<u>Example</u>**: Our firm was involved in litigation where the insurance company confirmation of beneficiaries on an annual basis was inconsistent with the insurance company's home office records and the Business Owner's partner received 50% of the insurance proceeds intended for the Owner's spouse.)

<u>Conclusion:</u> Successfully preserving a business to pass down to a family member(s) requires:

(1) Answering the seven essential questions (see page 3 of outline).

(2) Taking prudent risk management steps.

(3) Reducing the Owner's Exit Magic Number needed.

(4) Addressing family issues and expectations applicable to the particular Owner's family.

III. <u>THE OUTIE'S GAME PLAN</u>

The Outie's game plan normally includes selling the business to a third party for top dollars to Dance in the End Zone. Additionally, selling may fulfill the Outie's business legacy if customers, employees, and perhaps even the business's name continues forward because of the Owner's efforts and accomplishments.

> **<u>Business Exit Brokers:</u>** Interestingly, top business intermediaries typically sell only one-half (**1/2**) to two-thirds (**2/3's**) of the businesses they represent only after being engaged by businesses the intermediaries have determined to have a reasonable chance of successfully selling.
>
> **<u>Caveat:</u>** Due diligence by prospective buyers can be grueling, costly, disruptive and devastating if not properly managed by the Business Owners and Exit Planning Team. Financial results of a business are not the only criteria to attract a potential buyer; if this were the case, due diligence would take only the few minutes necessary to read the financial statements of the business rather than the weeks or months commonly taken for the purchaser's advisory team to pour over the books and records, the business facility, verify on premises and off premises assets and inventories, examine contracts and business relationships, interview management capabilities and acumen and go over every imaginable aspect of the business with a fine-toothed comb.

<u>ISSUE ONE</u>: Building Transferable Value for Outie's

Many Outie's make a massive mistake by allowing their businesses to become more valuable to them than to anyone else. If the Business Owner is the key employee, transferable value is undermined when the Owner exits the business because the business loses its most important employee.

The Exit Planning team must demonstrate to a potential purchaser that the business's efficient operations and ability to survive and thrive can be accomplished without the Owner's active involvement in the business so that the purchaser can be convinced that the business operations can be leveraged without the Owner.

Building Transferable Value may require growing the business in a different manner because it's not just about the Business Owner's desires, it's about "what is important to the customer or purchaser." The potential purchaser wants to know not only what the Owner did to create the business, but how it was done and whether the business is sustainable or scalable without the Owner on a going forward basis once the Owner "goes to the house." Transferable Value can be demonstrated by showing the purchaser that:

(1) The business is more profitable than industry averages or other competitors and how this excess profitability was accomplished;

(2) Operations are exceedingly efficient and how they work; and

(3) If revenues are up double digit percentages each and every year, how this positive trajectory was achieved.

Purchasers are looking for future results and are not interested in looking in the rear-view mirror at the Owner's past successes.

A. Playbook: Compelling Business Growth Plan

The Owner must demonstrate to the purchaser a Compelling Plan outlining how the business will grow at an attractive rate going forward **<u>at least for the next three to five years</u>.** The Owner must envision how the prospective purchaser will grow the business in the future and any distinctive competences that the business has to succeed in the future so that the Owner attains the proper price for such value. In the Owner's written Growth Plan, the following should be illustrated:

(1) Three to five ideas that could accelerate the business's growth, and at least a broad plan of action to implement such ideas;

(2) A summary of the business's competitive advantages and how they may be sustained and leveraged going forward; and

(3) A five-year pro forma financial model that gives purchasers confidence in the projected results.

Note: It is not necessary that the current Owner have the resources necessary to execute the business plan but that the prospective purchaser has access to such resources.

B. Playbook: Readable and Reliable Financial Statements

Transferable value can be diminished if prospective purchasers and their advisors cannot understand readily the Owner's financial statements and compare them against industry norms, or if they do not trust the accuracy of the Owner's financial statements.

Most sophisticated purchasers will want to review financial statements and possibly business tax returns for the past five years and sometimes longer.

Recommendations: Review with your Exit Planning team the following:

(1) How would a likely purchaser react to the current financial and accounting statements and methods used to prepare them?

(2) Are special issues accurately reflected in the footnotes to the financial statements?

(3) Do the business's statements accurately convey the business's financial strengths relative to peer companies? If not, why not?

(4) What are the business's weakest financial areas and how should these weaknesses be addressed?

(5) Ideally, having three years of audited financial statements might propel the success and timelines of closing a transaction (*if possible*).

C. Playbook: Document How The Business Works

Undocumented Business Process and Procedures are not easily scalable, sustainable or transferable. Transferable value increases when a business's operating processes, marketing tactics, selling techniques, planning methods, and other features of distinctive competences and capabilities are documented rather than left solely in the heads of the Business's Owner and Management because the potential purchaser's perceived risk is diminished.

Additionally, capturing these items in a written Business Plan will enhance the business's likelihood of growing in an efficient and profitable manner between now and the Owner's Exit.

D. Playbook: "Wild Card" Intellectual Property

Intellectual Property such as business brand, trademarks, service marks, and copyrights are the wild card of Transferable Value and can separate the Owner's business from the rest of the competition when prospective purchasers are comparing business purchase opportunities.

Caveat: The Exit team should verify that the business's name or logo does not infringe upon another business (i.e., a potential liability) and then develop a plan for creating and protecting intellectual property as far in advance of an Exit as reasonably possible.

E. Playbook: Desirable Contacts

An Owner should review and periodically update the business list or customers, suppliers, vendors, landlords, and employees and review the business's contracts from the perspective of a likely purchaser.

Recommendations: Ascertain whether contracts are transferable or assignable, rewrite them if possible in collaboration with customers and evaluate future contracts based on what is best for your business's growth needs, considering simultaneously what a potential purchaser might desire. The reciprocal benefit of this process in convincing customers that the business's product or service will remain available to the customer even beyond the Exit of the Owner likely will become an intangible asset of the business between now and Exit.

F. Playbook: Customer Diversification

Ideally, no single customer should exceed 10% of the business's top or bottom line profits.

Recommendation: Ascertain whether the business remains profitable with and without its largest customer and, if so, be prepared to share this story with a potential purchaser; if the Owner determines the business loses money without its largest costumer or customers, the Owner should take steps to reduce this risk to the Owner as well as to a potential purchaser.

G. Playbook: Upside Down Organizational Chart

The business must be able to function without the Owner as a key person because "nobody will purchase the Owner's job!" The longer the Owner remains the best person for a particular job on the organization chart, the business has a weakness not a strength on Exit. The

Owner must ascertain and document that the business will survive and thrive upon the Owner's Exit.

<u>Exercise:</u> The Owner should make sure the business has an accurate and sensible organization chart, place the owner's name at the bottom, turning the chart upside down relative to today and then determine whether business can perform without the Owner on top. If the business can be shown to be able to grow without its Owner as a key person, the prospective purchaser may be convinced that the business has a strong management team, a clear mission and vision, and effective operations.

H. Playbook: Normalized Earnings

Many Owners aggressively reduce their tax liabilities which understates the true profitability of their closely-held businesses and will need to "add back" to normalize profits some of the following items:

(1) Above market Owner compensation and benefits including expensive automobile leases, club memberships;

(2) Profit sharing and other retirement plan contributions;

(3) Compensation paid to the Owner's family members working in the business;

(4) Top rate rent paid for assets owned by the Owner outside of the business and lease backs, such as the business's office building and other facilities; and

(5) Business travel and generous accommodations.

<u>Recommendations</u>: An Outie should consider recasting financials now to normalize earnings regardless of how far away the Outie's target Exit age may be to avoid scrambling if a viable prospective purchaser knocks on the Outie's door.

<u>ISSUE TWO:</u> Anticipating the Purchaser's Desires

Although a purchaser's name may not be known ahead of time, the Outie and the Outie's Exit Planning Team should profile and formulate a likely purchaser list either alone or with an "intermediary," such as a broker investment bank, or "Merger and Acquisition" specialist, identified to assist in the Exit. In the case of larger businesses, the "intermediary" can develop a game plan for a road show or controlled auction to generate purchasers' interest to enhance the Exit price.

Types of Purchasers: Purchasers of medium to large businesses fall into two main types – *financial and strategic*:

(1) Financial Purchasers. Financial Purchasers such as private equity groups focus on the business's rate of return as an investment opportunity, using a combination of debt and their own cash, and will desire businesses with competent management and the potential for exponential growth. Normally, the Financial Purchasers will try to lock in the management team (and possibly the Outie as well) into a three to five-year contract, purchasing a portion of the business [usually majority control], with a second sale of the business ± 5 years out (i.e., a "private recapitalization)." Private recapitalizations can achieve a bigger financial win for the Outie if the business grows significantly between the first and second sale, but the "Outie may be selling his soul to the company store." The Outie who can demonstrate the existence of a strong management team without the Owner may be able to affect a management buy-out without the Outie, but also may be compensated with a purchase price consisting of a down payment/up front portion with a large earn-out deferred purchase price.

(2) **Strategic Purchasers**. Strategic Purchasers look for "synergy" in the targeted business and usually consist of another business already in the same industry or hoping to expand into a complementary industry. A rule of thumb is that a strategic purchaser likely will be from 5 to 20 times larger than the Outie's business.

Unlike a Financial Purchaser, a Strategic Purchaser (other than requesting the Outie to execute a non-compete/non-solicitation agreement) may be less concerned with the Outie or the Outie's management team sticking around long after the sale.

A possible disadvantage of selling to a Strategic Purchaser is that the Outie's business may not continue as a stand-alone entity after the Owner's Exit and the Owner's brand name may go away.

(3) **Initial Public Offerings (IPO).** For larger businesses, "going public" can be an exciting Exit Strategy for the successful Outie. This option may bring liquidity and a premium price, but not without a cost in legal fees, investment banker charges, etc., as well as a myriad of securities' regulations and reporting requirements.

<u>ISSUE THREE:</u> Aligning in the Outie's favor the Three T's: Timing, Terms and Taxes.

When exiting a business, two numbers are more important than the gross sales price: First, the Outie's Exit Magic Number calculation because it represents how much the Outie needs to achieve financial freedom. Second, the Outie's net amount received after taxes and other Exit expenses (which could include phantom stock payments or other incentives paid to management to go along with the proposed transaction).

<u>Asset Sales versus Stock Sales</u>. Normally, an Outie may desire a stock or membership interest sale to obtain preferential capital gains tax treatment (especially if a C corporation is involved) and simplicity, although a potential purchaser prefers an asset sale for two reasons: first, to reduce risk to unknown pre-sale liabilities and second, to write off for tax purposes as much of the purchase price as possible as quickly as possible under federal tax rules.

<u>Caveat:</u> If an asset sale is selected, the Outie/Seller and Purchaser must execute an IRS Form 8594 (and attach them to their respective tax returns for the year of the transaction) to perform a "Purchase Price Allocation" to the assets being sold. The Purchase Price Allocation can be a bone of contention and deal breaker because the Outie/Seller wants to obtain preferential capital gains tax treatment while the Purchaser wants to deduct as much of the Purchase Price as quickly as possible.

<u>Solution:</u> In any asset sale, the Exit Planning Team should negotiate the Purchase Price Allocation and agree to a mutually acceptable Form 8594 as quickly as possible during the due diligence period and agree to attach the Form 8594 as an exhibit to the Purchase Agreement to prevent post-closing bickering and unnecessary legal and accounting costs.

I. Playbook: Tax Analysis and Plan Business

Fewer than 10% of Business Owners have a written analysis of the tax impact prior to Exit.

<u>Recommendation</u>: Well in advance of any potential Exit, the Exit Planning Team should evaluate the tax impact of an asset versus entity sale and structure the business as efficiently as possible to minimize taxes on Exit, balancing against any increased income taxes between now and such potential Exit.

J. Playbook: Ideal Legal Business Entities

Although tax laws continue to change, generally pass through entities such as S Corporations, partnerships and limited liability companies (rather than C Corporations) are the entities of choice. In more sophisticated businesses, it may be possible to combine C Corporations and pass through entities to get the best tax benefits of each entity (i.e., the bracket ride of a C corporation from **15%** up to the maximum taxation while mitigating against double taxation of a C Corporation on Exit).

K. Playbook: Conversion of C Corporation to S Corporation

Although converting an existing C Corporation to S Corporation status can be accomplished, the taxpayer should wait beyond the five-year built-in-gain (BIG) recognition period before selling an interest in the business or substantially all of its assets to avoid BIG double taxation. As mentioned previously, the double taxation occurs because the Corporation itself is taxed first when the assets are sold and the Owner is taxed again on the distribution of the net assets when the Corporation is liquidated.

Recommendation: To minimize the built-in gains tax exposure, the business's assets should be valued as of the conversion date to track the built-in gains tax exposure on sale, particularly, if the business is growing significantly.

L. Playbook: Personal Goodwill

To mitigate against double taxation on the sale of a C corporation's assets, if the Purchaser pays for the Owner's "personal goodwill" rather than "business goodwill," then the payments are subject only to one level of taxation; the Purchaser winds up with the same tax treatment (i.e., the cost is amortizable over **15 years** under Internal Revenue Code Section 197). Personal goodwill requires an identification of the Owner's talents, relationships, and skills as a source of valuable separate and apart from the business; the more the business depends on the Owner, the more an argument can be made for a purchase price allocation to personal goodwill.

> **Recommendation:** A separate Purchase Agreement should be executed for the sale of business assets and the Owner's personal goodwill.

> **Caveat:** The Owner and Exit Planning Team should anticipate that a prospective purchaser will insist on the Owner executing an Employment Agreement containing a non-compete covenant (and similar restrictions) if personal goodwill is purchased and any attempt is made to allocate a portion of the Purchase Price to the Employment Agreement, taxable as ordinary income upon receipt to the Owner and may attempt to stretch out the maximum non-complete period (2 years under Louisiana law) by attempting to run the non-compete period from the end of the term of the Employment Agreement rather than from the date of sale.

M. Playbook: Section 1202

Under IRC Section 1202, an Owner may be able to exclude 50% of the taxable gain realized when the Owner sells the business up to $10 million or 10 times the Owner's basis in the stock, whichever amount is greater. The requirements to qualify for Section 1202 are:

(1) The business must be a C Corporation;

(2) The stock must have been issued after August 11, 1993 and have been held for longer than 5 years;

(3) The aggregate gross assets of the corporation must have been less than $50 million at the time of and immediately after issuing the stock; and

(4) The business must be involved in certain industries such as manufacturing, wholesaling and retailing, excluding farming and many service industries.

Some benefits from Section 1202 may be eroded by alternative minimum taxes.

N. New Company

As mentioned previously, one additional tactic for Outie's with C Corporations is to migrate business, revenues, profits, assets to a new flow through entity such as an S Corporation or LLC, while freezing or reducing the value tied up in the existing "C' Corporations.

O. Playbook: Stock Swap

If the Purchaser Business offers its stock rather than cash, it may be possible to effect a tax-free swap under the Internal Revenue Code. Two essential requirements to qualify for a stock swap include:

(1) The Owner must receive voting stock in the Purchaser's Business; and

(2) The Purchaser usually must purchase at least 80% of each and every class of stock in the Owner's Business.

Caveat: Often the stock acquired by the Owner is "restricted stock" which may not be permitted to be sold after the swap for a period of time such as two or three years. Sometimes "collars" can be acquired by the Owner to hedge against a dramatic drop in the stock of the Purchaser's Business if it is public stock and there exists a sufficient market.

P. Playbook: Royalties and Earn-outs

Royalties and earn-outs may be included in a sale in addition to upfront cash. A royalty agreement pays additional cash to the Owner if sales or profits from a specific product or service exceed certain benchmarks. Royalties and earn-outs may be included in a sale in addition to upfront cash. A royalty agreement pays additional cash to the Owner if sales or profits from a specific product or service exceeds certain benchmarks. Royalties and earn-outs commonly are used when the Owner and the purchaser have a different view of the Owner's business in the future and the purchaser recognizes a weakness in the business.

Recommendations: If the Owner loses control at the time of the sale, the Owner's Exit Planning Team should insist on earn-outs being tied to gross revenues rather than bottom line profits to reduce the level of scrutiny needed by the Owner to make sure all earn-out payments are being made under the agreement. Also, although the deferred earn-out payments can be accounted for under the installment gains method, a portion of the earn-out may be treated as **"imputed interest"** taxable as ordinary income under the tax law, and the imputed interest portion could be significant if the earn-out period is extensive and the risk of meeting the earn-out benchmarks may increase as the Owner loses control of the business.

Q. Playbook: Employment Contracts

Many purchasers may want to include a portion of the Purchase Price in an Employment Contract to increase the portion of the Purchase Price deductible by the Purchaser and to keep the Owner focused to maintaining the profitability and customer relationships of the business being sold.

Benefits: The Employment Agreement may increase the amount the Owner receives for the business and may enable the Owner to continue receiving benefits and perks from the business with pre-tax dollars.

Burdens: The compensation payable to the Owner under the Employment Contract will be subject to ordinary income tax rates and payroll taxes.

Caveat: The Employment Contract should be separate from the Purchase Agreement to prevent the Purchaser from attempting to void the transaction for non-performance if the Owner terminates his or her employment.

R. Playbook: Installment Sales and Escrows

Whether an installment sale is effected or not, a portion of the sales price may be escrowed to ensure that certain representations and warranties made by the Owner are met. The sale can be structured to defer taxes until the escrowed funds are released.

S. Playbook: Consulting Company

Instead of remaining as an employee, the Owner may wish to remain engaged with the business for a period of time as a consultant. The Owner should consider setting up a consulting company as a corporation or LLC to contract for and deliver services rather than personally delivering the services.

Benefits:

(1) Utilizing a tax-deductible Retirement Plan inside the company to shelter earnings from income taxes.

(2) If a C corporation is used, employee benefits such as medical insurance or private long-term care insurance may be obtained in a tax favorable manner.

(3) The Owner can use the company to hire other parties to perform the services.

(4) Upon death or disability of the Owner, another party can deliver the services to avoid forfeiting its revenues.

III. <u>THE INNIE'S GAME PLAN</u>

Owners who intend to sell their businesses to key employees are called Innie's, who may be the best, in some cases, the only potential Purchasers. The Owner and his or her employees could pursue an Exit implemented gradually over time where ownership and/or control is transferred in stages. A gradual transfer can help reassure customers, lenders and other employees of an orderly and ultimately successful transition and accommodate employee Purchasers who do not have sufficient cash or collateral to purchase the business.

<u>Challenges:</u> Some additional challenges to an Innie is the identification of employees to purchase the business and being able to retain the designated employees and keep them from being lured away by competitors and not losing the employees to death or disability during the process. Innie's need to address the following issues to Dance in the End Zone:

(1) Transferring control in an orderly manner;

(2) Favorably aligning the three T's: Timing, Terms and Taxes; and

(3) Reducing default risk.

<u>ISSUE ONE:</u> Transferring Control in an Orderly Manner

Most Innie's (or Owner's in general) are very concerned about control; if the employees have been running the business without the Owner for several years, the Owner may be several steps ahead, but this is rare.

A. Playbook: Sale to Employee(s) Feasibility Study

Before proceeding with an Exit, an Innie should meet with the Exit Planning Team and start with a formal assessment or "feasibility study" and begin with a SWOT Analysis of the Purchasing employees: examining their strengths, weaknesses, opportunity and threats. Additionally, the following should be considered:

(1) The Owners' roles and responsibilities today and which ones the Owner would like to shed and when?

(2) The professional strengths and personal weaknesses of the top employees targeted as purchasers.

(3) Identifying the next CEO.

(4) Any holes or weaknesses in the management team and how to fix these gaps.

(5) How will others such as non-purchasing employees, customers, suppliers, and lenders react to a transaction and how to assuage any concerns?

(6) Under what circumstances will the Owner comfortably transfer strategic control?

<u>Game Plan</u>: Conduct the SWOT Analysis, answer the questions and map-out the work needed to get everyone ready.

B. Playbook: Control Checkpoints *(same as for Passers)*

Control Checkpoints can be borrowed from the Passer's playbook not only is giving up control all at once not necessary, it's usually not healthy for the business and the employees. Consider the following:

(1) Diagram with the employees the business's organizational chart as it exists today and will exist going forward to discuss shifting roles and responsibilities.

(2) With collaboration of the purchasing employees, write job descriptions and set clear performance expectations.

(3) Review with each purchasing employees his or her strengths and weaknesses and identify a plan for building on strengths and improving weaknesses.

(4) Delineate in writing control checkpoints and meet frequently to measure success.

C. Playbook: One-way Buy-Sell Plan

Before transferring significant "control" or actual ownership, transfer some of the risks and responsibility of ownership, such as asking the targeted purchasers to guaranty some of the business loans or skip a paycheck or two because of tight cash flow, or agonize over a no-win situation such as terminating an employee or two. While shifting risks and responsibilities and devising a game plan for the ultimate shifting of ownership and control, a One-Way Buy-Sell Plan can be executed obligating the targeted purchasing employees to purchase the business in the event of the Owner's death or permanent disability. This legally binding commitment can be funded with life insurance or disability insurance if available, and the cost of such insurance paid by the purchasing employees will get them to put some skin in the game. If any of the targeted employees are unwilling to fund the modest costs of insurance to protect the business and their career options, the Owner likely will be uncomfortable in counting on such employees to consummate the purchase and prudently make significant decisions for the business.

ISSUE TWO: Aligning in the Owner's favor the three T's: Timing, Terms and Taxes.

When the Innie goes to sell to the targeted employees, an evaluation must be made of the available cash generated by the business to fund the agreed upon purchase price without starving the purchasers after the business profits are reduced by the purchase price obligation and income taxes.

D. Playbook: Sell the Business for the Minimum Reasonable Value

Rather than selling a business for its gross value and triggering inordinate income taxes and capital gains taxes, steps should be taken to supplement the sale with one or more compensation-based programs that are deductible to the business, which may reduce the total tax bill and ease the financial strain on the business, especially in early years. To offset the higher tax bill to the Owner/Seller, the compensation amounts and deductible fringe benefits payable to the Owner could be increased.

E. Playbook: Employment Contract

In exchange for reducing the Purchase Price to the targeted purchasing employees, the Innie might remain employed by the business and continue to receive reasonable compensation for actual services and benefits such as medical insurance, a company car, etc., all of which is deductible by the business to ease the business's cash flow, but includible as ordinary income to the Innie.

F. Playbook: Consulting Company *(variation from Employment Contract)*

Alternatively, instead of remaining an employee, the Innie can create a consulting company and received reasonable payments for consulting services rendered by the Innie to his or her consulting company (taxable as ordinary income subject to self-employment payroll taxes) but with some added benefits:

(1) Establishing a tax-deductible retirement plan inside the consulting company to shelter and defer earnings from income until a future date when needed or desired;

(2) Utilizing a C Corporation structured for the consulting company to provide the Innie with employee benefits such as medical insurance or private long-term care insurance on a tax favorable basis; and

(3) Being able to hire other parties to provide the services in the event of the Innie's death, disability or declining health.

G. Playbook: Salary Continuation Plan

As mentioned previously with regard to a Passer's Exit, an Innie also can enter into a written formal compensation agreement to continue receiving reasonable salary payments after termination of the Innie's services to reduce the cash flow burden of the business and enhance the overall Purchase Price package payable to the Innie; however, the Innie will incur ordinary income tax treatment and not have access to company benefits since employment with the business will have been terminated. An estate tax planning benefit is that the value of the contingent liability may need to be included in the business's financial statements justifying a reduction in the value of the business for estate tax valuation purposes, although the IRS might assert that the Innie has to include some value for the salary continuation plan in his or her estate.

H. Playbook: Asset Lease Backs

If the business utilizes commercial real estate, equipment or intellectual property owned by the Innie outside of the business entity, the purchase price of the business may be able to be reduced but the Innie might be able to continue receiving cash flow through rent from the business after the Exit. A long-term Lease at the highest reasonable rental rates should be executed as a separate agreement alongside the Business Sales Agreement.

I. Playbook: Employee Stock Ownership Plan (ESOP)

Although beyond the scope of today's presentation, an ESOP might be considered if the business has a strong management team that could result in rollover tax treatment for the Innie, control shifted to the management team (through a part sale of stock by the Innie directly to management team members), and the ability to provide ownership in the business to a significant portion of the business's employees.

<u>ISSUE THREE</u>: **Reducing Default Risk**

Because the targeted purchasing employees may have insufficient cash or collateral to purchase the business, Innies may need to assist their employees to purchase the business, either by Owner-Financing a portion of the purchase price, pledging the business as collateral against a third-party loan, or both. Although the Innie can take steps in advance of the Exit to reduce his or her Exit Magic Number to help the targeted employees successfully purchase the business, even a purchase price reduction and the use of strategies to complement the purchase price and reduce the purchasing employees' cash flow burden may not work and the Innie and Exit Planning Team need to assess the risk that the Innie may be forced to reacquire the business if the purchasing employees cannot meet their payment obligations or the Innie's financial freedom and legacy may be lost.

J. Playbook: Transfer the Risk

One solution to reduce or eliminate the default risk to the Innie is to transfer the risk to a third party. The purchasing employees would purchase an amount from an insurance company funded through business profits and the insurance company (at a cost) would guarantee the payments to the Innie under the terms of the annuity contract.

K. Playbook: Insurance on the Employees/Purchasers

The Innie should require the targeted purchasing employees (who hopefully are younger and insurable) to acquire life insurance and disability insurance on themselves in a sufficient amount to secure payment of the deferred purchased price owed to the Innie by the purchasing employees in the event one or more of the purchasing employees dies or becomes disabled before the Innie receives full payment on the sale of the business.

L. Playbook: Golden Handcuff Plans

A tactic to reduce defection by the targeted employees between now and Exit is to fund with the business's cash flow a "Golden Handcuff Plan" that vests with the purchasing employees at the time of Exit and can be used by them toward satisfaction of the purchase price to the Innie.

IV. THE SQUEEZER'S GAME PLAN

Although an Owner may have a profitable business that enjoys a significant cash flow, Squeezers recognize that nobody is likely to pay for their business's goodwill or going concern value because for whatever reason the Squeezer does not have family members or key employees who can take over the ownership and successful operation of the business. Thus, the goal of the Squeezer is to squeeze every single dollar out of the business between now and Exit in order to achieve financial freedom and Dance in the End Zone.

The smaller the business, the greater the potential for a Squeezer, although large construction companies and similar types of businesses may be able to sell only for their equipment's net book value. Many professional service businesses (attorneys, CPA's, Consultants) inextricably are tied to the talents or relationships of the Owner and certain other industries offer little barrier to entry, making it easy for competition to get started or build market share without having to write a check for the business. Squeezers absolutely need an Exit Plan in order to achieve financial freedom.

ISSUE ONE: Reduce Exit Magic Number to Zero

Since the Squeezers are likely to receive little or nothing upon Exit, they must reduce their Exit Magic Number to zero. There are CPAs and Attorneys we work with who are squeezing out as much cash and as many perks from their business as possible with the understanding that their lieutenants will just take over the lease of the office space and possibly continue to pay them a percentage of services or consulting fees the Squeezers generate for a period of time after the Exit, which may be a perfectly acceptable Exit strategy for the Squeezers to obtain financial freedom for the Squeezer and his or her family.

ISSUE TWO: Ordering Transition for Employees and Customers

Regardless of their Exit strategies, many Owners feel a strong need to treat fairly their valued employees, customers and close relationships at Exit. Squeezers face an additional challenge with employees and customers; and the knowledge that the Squeezer will be unable to employ the employee or service the customer upon Exit may cause the younger employees and long-term customers to head for the hills well in advance of the Squeezer's Exit time if the Squeezer ignored these real concerns. It is critical for the Squeezer to transition service provider relationships well in advance of the Exit and to make arrangements for top employees either through "Golden Handcuffs" or other tactics to prevent their defection.

ISSUE THREE: Orderly Liquidation of the Business

Although much of the actual work takes place close to the Exit, if the Squeezer is prepared ahead of time, he or she can minimize mistakes and avoid missed opportunities.

Playbook: Business Wrap Up Plan

The Squeezer and his or her Exit Planning Team should make a checklist and cover the following:

(1) Discuss legal procedures to shut down the business property;

(2) Identify sellable assets at Exit, and tax implications and steps to reduce such taxes;

(3) List proper steps to terminate contracts such as equipment leases, employment agreements, and customer agreements, paying careful attention to leases that might run beyond the Exit Date;

(4) Discuss steps necessary to terminate retirement and other employee benefit plans; and

(5) Identify local, state and federal agencies to notify.

V. <u>THE MAGIC NUMBER</u>

The Owner should calculate the after-tax amount needed from the Business to achieve financial freedom.

To accomplish financial freedom upon Exit, the Owner must know his or her Exit Magic Number, which is the amount the Owner needs to extract from the business to achieve financial freedom and not outlive his or her family's resources. The smaller the Exit Magic Number, the greater the financial freedom outside of the business.

Throughout this presentation, strategies were introduced to help the owners identify ways to reduce the Exit Magic Number, which should include consideration by the Owner and Exit Planning Team of the following:

A. Playbook: Tax-Leveraged Retirement Plans

Depending on the number and nature of the employees employed by the business, the Owner may be able to transfer significant amounts from the business outside of the business into deductible profit sharing plans, including 401(k) plans and possibly Roth 401(k) plans.

B. Playbook: Asset Lease Backs

As mentioned previously, identify commercial real estate, equipment and intangible assets that can be owned by the Owner outside of the business so that post Exit these assets can be leased back to the business or to others to reduce the Exit Magic Number by generating sustainable cash flow outside of the business.

C. Playbook: Reinvest/Receive Ratio

The Owner and Exit Planning Team should develop a ratio, particularly if minority owners are involved, that identifies what percentage of the business's net profits (cash flow) will be reinvested into the business and what percentage will the Owner(s) receive and take home in distributions; this analysis results in the Reinvest/Receive Ratio. Just like a budget, assumptions must be tested on a periodic basis (at least annually) so that adjustments can be made to remain on track on a going forward basis.

D. Playbook: Ideal "Strategic" Asset Allocation *(Sample)*

An examination should be made of where the Owner currently is positioned compared to an ideal targeted asset allocation and steps taken to get there. For example, a Strategic Asset Allocation may look as follows:

Asset Classes	**Current Allocation**	**Ideal Allocation**
Closely-held business	80%	60%
Illiquid real estate	13%	10%
Marketable securities in retirement (illiquid) accounts	4%	10%
Marketable securities in after-tax (liquid) accounts	2%	15%
Cash	1%	5%
Total:	**100%**	**100%**

VI. CONCLUSION

The Owner should consider the following additional steps in contemplation of exiting the business:

(A) A written analysis of the Exit Plan's tax impact has been made, and the Owner is implementing tactics to address taxes.

Less than 10% of Business Owners have any idea of the net after tax dollars they will receive on Exit, and may have not examined this issue even at the time they have executed a Letter of Intent or Binding Agreement to sell. The Owner and Exit Planning Team must meet on a periodic basis discuss an Exit Planning Strategy, compile a list of possible suitors, consider the most likely path of an Exit (asset versus entity sale) and then compute a pro forma of the tax liability that would not erode the Owner's net after tax Exit number. Once this analysis is performed, steps should be taken and monitored so that the Owner knows approximately what he or she will net before spending the time or energy to entertain an Exit offer.

(B) The Owner has been taking the extra cash out of the Business each year, in a tax favorable manner, to increase the Owner's net worth outside of the Business between now and Exit.

No matter how much insurance the Owner may have, and even if the Owner swears on a bible that he or she can generate a 15% internal rate of return on the business assets and employ every single available dollar of capital, steps should be taken to remove cash from the business, increase net worth outside of the business and reduce the Owner's Exit Magic Number, and avoid retaining too many assets inside the Business.

(C) Available tactics have been implemented to reduce creditor risk against Business and personal assets.

As part of any Exit Plan, "asset protection planning" should be considered, evaluating which assets are protected from creditors under federal bankruptcy laws or state creditor laws and a *financial statement prepared in a dashboard* for the Owner to measure these items quickly in order to convert the exempt/non-exempt allocation of assets to an ideal allocation commensurate with the Owner's risk tolerance and financial freedom goals.

(D) The Owner has assembled trusted tax, legal, and business advisors who are qualified to help implement the Owner's Exit Plan and the Exit Team meets regularly, not less than annually, to address and advance the Exit Plan.

An Exit Plan is dynamic and must be reviewed periodically with the Exit Planning Team consisting of the Owner's regular business advisory team as well as specialists employed to develop an appropriate Exit Strategy.

(E) The Owner has shared his or her Exit objectives with his or her spouse and Business partner(s), who have become aligned with the Exit objectives and have little to no concerns.

This information together with a written Business Succession Plan is invaluable in meetings with the Business Owner's spouse to assure the spouse that the spouse will not be financially devastated on the Owner's death, disability (or even divorce). Likewise, all business partners who own a company must discuss their Exit goals and timing to make sure they are operating and growing the business in a fashion to execute a proper Exit, especially when it is revealed that the Partners have different Exit Numbers or Exit Timetables. It may be necessary to effect an Exit for one or more partners at a different date than other parties, which happens frequently with personal service businesses (engineers, doctors, attorneys, CPAs, consultants, veterinarians, etc.) and other closely-held Business Owners.

(F) The Owner has clearly discerned a vision of what the Owner wants to do with his or her time and talent after Exit, and has no concerns that life after Exit will be unfulfilling.

(G) The management team can run the business for up to several months without the Owner's involvement.

As mentioned previously, in order for a Business Owner to maximize the purchase price on Exit, the Owner must convince the prospective purchasers that the business can survive and thrive without the Owner running day-to-day operations or even overseeing all strategic decisions employed by the business.

In addition to having a mature and capable management team in place at the time of the Exit, what happens if before a planned Exit the Owner dies or becomes permanently disabled or desires to take an extended vacation to a remote place? In many of our business engagements, we discuss having the Owner execute a Conditional Special Business Power of Attorney (identifying and naming co-agents who are capable of running the business during the Owner's extended absence or disability) and incorporating in the Owner's Will a subtrust to own and operate the business and to effect the Exit after the Owner's death (with co-trustees who may include the same team as the co-agents under the Conditional Special Power of Attorney).

(H) Financial statements are timely, accurate, and formatted in a manner consistent with industry and business norms, and audited by an independent accountant.

During the last few years we have represented Business Owners who have lost significant opportunities to Exit because of inadequate or unintelligible accounting records, primarily in situations where we have taken on the Owner's Business Representatives recently or had not been engaged by the Owner to handle Exit Planning. The cost of using a reputable CPA firm specializing in a particular industry segment is invaluable in effecting a successful Exit and enhances the Purchase Price as well as assisting in consummation an Exit without unpalatable Escrows and Holdbacks related to the Owner's Representations and Warranties or the need for a significant earn-out portion and timeline to receive the Purchase Price.

(I) The company follows a written Business plan, with detailed financial projections, to pursue significant growth over the next several years. The Business plan is aligned with the Owner's Exit Plan.

As mentioned previously, a perspective purchaser will expect to review a written Business Plan explaining the distinct competiveness of the Business, the strategic opportunities of the Business and any other material information that causes the Business to be able to compete successfully and grow within its industry. The more detailed such written business plan contains, the more likelihood that the Business will gain the attention of a perspective purchaser and his or her advisory team. It is critical that the business plan be aligned with the Owner's Exit Plan so that a transaction can be consummated as expeditiously and effectively as possible.

(J) Top employees have formal financial incentives to stay with the Business until at least two years after the Owner's Exit, and have signed non-solicitation and/or non-compete agreements.

In order to protect its intellectual property and to prevent the defection of the Business's top employees during the operation of the business, the Business should have its key employees execute non-solicitation and non-competition agreements as a matter of course and have an arrangement with the key employees well in advance of any Exit regarding whether the top employees will agree to remain with a prospective purchaser. If the Owner intends to share a portion of the purchase price with the key employees as a thank-you for long term service, the Owner may wish to enter into a phantom stock arrangement or similar plan to ensure that the business's management group stays intact and is willing to join the prospective purchaser. One major benefit of this type of arrangement is that the Owner may be able to offset its ordinary income by the payment of the phantom compensation arrangement on the eve of closing and at the same time maximize the portion of the purchase price eligible for capital gains treatment.

As an added bonus, all or a portion of any capital gain on the sale of a non-publicly traded business domiciled in Louisiana held by the taxpayer for a minimum of five years may be excludible from Louisiana state taxation **depending on the length of the time the business is domiciled in Louisiana**,* **phased-in over a period of thirty years:** for a sale of an entity domiciled in Louisiana for greater than five years but less than ten years prior to the sale or exchange – the capital gains deduction shall be 50%; greater than ten years but less than fifteen years – 60%; greater than fifteen years but less than twenty years – 70%; greater than twenty years but less than twenty-five years – 80%; greater than twenty-five years but less than thirty years – 90%; and for entities domiciled in Louisiana for greater than thirty years – 100%. Thus, it may be highly beneficial from a Louisiana tax standpoint to delay a sale until the next five-year threshold is met; in particular, for a new business or newly Louisiana domiciled business, attaining the initial five-year phase-in period provides the most immediate benefit (i.e., 50% exclusion from 0%). ***Note: prior to 2016, this exclusion on the sale of a Louisiana domiciled business was 100% without a thirty-year phase-in period. This additional time requirement must be considered on all Louisiana business sales going forward.***

In addition to capital gain treatment, consideration should be given to the applicability of the **3.8%** net investment income (NII) surtax. Briefly, for active trade and business income, the NII surtax should generally not apply; however, the NII rules can vary depending on the entity and circumstances, and the NII surtax can apply to any property not attributable to an active trade or business, as it may also apply to income or loss on working capital. Generally, a gain on the sale of partnership interests (or membership interests in a Limited Liability Company taxed as a partnership) by a partner <u>who materially participates in the business</u> should be exempt; as such, the Owner should consider adjusting his or her level of activity within the business well in advance of a proposed sale. The sale of stock in an S Corporation, on the other hand, will be subject to the NII surtax, regardless of participation of the shareholder, unless it meets an exception under Internal Revenue Code §1411(c)(4). Further, the NII surtax may apply to interest arising from the sale, including interest on any installment notes (or imputed interest on such notes), which is ordinarily treated as passive income, as well as any income from a continued ownership interest in the business when the Owner no longer materially participates. Therefore, adequate planning may be necessary to minimize or restructure installment payments and to ensure adequate participation levels for the Owner while he or she exits the business.

(K) The largest customer(s) accounts for a Business for no more than 10% of its current top line revenue.

Unless the Business Owner is able to demonstrate that the Business remains profitable with, as well as without, one or more of its largest customers, in order to prepare for a successful exit, the Business Owner must take steps to diversify its customer base so that the Business is not subject to the whims of any large customers in order to remain profitable.

(L) The Business has written procedures for the important sales, operational, and financial processes, allowing the Business to readily train and cross-train current and future employees.

As part of its written Business Plan, the Owner should make sure that detail procedures are delineated for generating important sales of the Business as well as process and procedures for the operation, financial reporting, training and development and overall development of its key employees and the maintenance of its critical business relationships.

CALL TO ACTION: PLANNING TODAY FOR TOMORROW'S EXIT:

In order to enhance the likelihood that a Business Owner will "Dance in the End Zone" on Exit the Owner immediately and without delay should:

(1) Perform a SWOT Analysis of the Owner's Business and its Management Team (i.e., exam strengths, weaknesses, opportunities and threats).

(2) Compile an Exit Planning Team of advisors and meet regularly to monitor alignment of owner and management with the Exit Plan and potential Purchasers of the Owner's Business.

(3) With the Exit Planning Team and Key Employees prepare a written Business Planning defining all crucial ingredients of the Business (i.e., processes and procedures, profit pro forma statements, customers and customer prospects,

strategic planning opportunities including distinctive competences of the Business, personnel training and development plans, etc.).

(4) Delineate goals and objectives for a successful Exit including projected Exit date or criteria, likely Exit strategy, Exit Magic Number calculation for Owner(s), attainment of alignment of multiple owners and key management to accomplish Exit Plan.

(5) Discern a Life Plan after Exit to navigate from $uccess to Significance and make sure family expectations are considered for all family members.

(6) Implement and don't look back!