SUCCESSION PLANNING:
Finding your exit

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For some, owning a company is the American dream. At some point in their lives, many Americans will develop and own companies. Some will thrive, and some will fail. For the ones who develop successful companies there will come a time where they will transfer control through sale, retirement, or even death. This article will discuss options such as owners selling to key employees or family members, selling to an outsider, employee stock ownership plans (ESOPs), and following the owner's death by way of the owner's estate plan.

Selling to a family member or a key employee:
Often, ownership of closely-held companies stays within families or among key employees for extended periods of time, and the companies become interwoven with the families and communities in which they are developed. As a result, it is important for the founders of these companies to maintain certain values and work ethics.

It is not always easy to find the right heirs or key employees who embody the same values and work ethic upon which the company operates. Frequently, the "right" individual lacks the financial means to purchase the company. That issue often poses the greatest challenge to transferring to family members or key employees. Consequently, many owners who choose to go this route typically end up "becoming the bank" within the succession plan if the potential purchaser is unable to receive a bank loan. If the owner extends credit, then the loan is secured by a promissory note and the tax consequences may be inefficient. One technique for this scenario includes the company issuing a bonus to the individual to service the existing loan payments. These bonuses will be taxed to the employee receiving the bonus; therefore, the company will have to bonus significantly more to 'gross up' enough for the employee to make full payment on the note.

Selling to an ESOP:
This is where an ESOP can be a great advantage for key employees, family members and owners to mitigate against unintended tax consequences. Using the ESOP as the purchaser will significantly save on taxes as it will allow the company to deduct ESOP contributions used to pay loan payments on the debt. In addition, the purchaser is not taxed on the balance the company contributes to the ESOP. ESOPs are complex and are not a universal solution, but the benefits merit investigation in many succession plans.

Selling to an outsider:
Selling to someone outside of the business is appealing to some owners. Maybe you are attracted to the thought of selling to a private equity buyer or a competitor with hopes that you (as the owner) can simply receive cash and walk away. This is rarely the case with most companies, as most buyers will insist on the owner sticking around for some time after the sale to secure their investment and to assist with the transition. Sometimes owners in position to sell will believe that they will receive more money from these third-party purchasers than other options. Depending on how the entity is set up - either as a limited liability company, S-corporation or C-corporation - there are different tax consequences on which your business CPA will be able to advise.

Owning the company until death:
Some owners take great pride in their business and intend to own their companies until they die. What does this say to potential key employees or even family members who desire to someday own the company and who intend to put years of sweat equity into the company? Does it mean they will have to wait significant years before the owner dies to have potential ownership? What if the owner does not have sufficient estate planning? Waiting for death brings much uncertainty to interested parties. This uncertainty can eventually lead to resentment and potential for movement of key employees, and even family members, to competitors or other companies. Additionally, when a plan is delayed, developments can dramatically alter the results. Thus, waiting to transfer ownership until dying from old age is not ideal.

Many strategies exist for owners exiting their businesses. Regardless of the path, it is imperative for an owner to put together a team which should include a business attorney, estate planning attorney, business CPA, and financial planner to understand his or her personal needs and goals for retirement and succession.

Jay Kakaty is an experienced attorney practicing in the areas of estate planning, business planning, and entertainment law. Jay helps his clients, their families, and their businesses plan for the future and navigate life's legal challenges. Jay also has extensive experience representing entertainers and artists around the country. Jay represents clients throughout Michigan, regularly spending time in each of the firm's offices.

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