Avoiding Disasters in Insider Transfers

Steve Smith was no different than millions of other baby-boomer business owners in that the thought of leaving his business was never far from his mind, no matter how far away his exit might have been. He daydreamed about transferring the business to his oldest daughter and perhaps to a member of his management team, yet he couldn't gauge their passion for owning a business and hadn't tested their management skills.

And, of course, they had no money.

Steve's company was his economic and financial lifeline. Without its income, his ability to use the business to accumulate wealth, the ability to sell his interest to a buyer who had cash, and a plan, Steve's wishes would never come true. To Steve, it was obvious that if he ever wanted to exit his business in style, he needed to wait for a white-knight buyer to appear on his doorstep bearing saddlebags of cash. So, Steve did what many other owners in his position do: nothing.

If you think that transferring your business to your children or management team is inherently risky, you are right.

Insider transfers are risky for three reasons:

1. Insiders have no money
2. Successors' management/ownership skills and commitment to ownership may be untested
3. Owners lose control of the business if they make the transfer before they are completely cashed out.

On the other hand, the possible benefits of an insider transfer include the following:

1. Keeping the business in the owner's family or extending the owner's legacy through his or her hand-picked management group.
2. Motivating, retaining, and rewarding key employees.
3. Reaping more after-tax money than a third-party transfer.
4. Retaining control until all, or most, of the purchase price is received.
5. Remaining active in the business while gradually reducing day-to-day responsibilities.
6. Providing time for owners to build up personal assets (via distributions of cash) before their exits.

The trick is to design a plan that minimizes risk so owners can reap all of the potential benefits. Let's first look at how that might be done.

1. Insiders have no money; therefore, it is too risky to sell to them. That's true if owners don't design a transfer strategy that puts money in the insiders' pockets as they increase the value of the company. Owners have to work steadily and effectively to build cash flow (the source of all cash outs) through (a) the installation of Value Drivers and (b) careful planning to minimize taxation years in advance of the transfer.

Unless owners carefully plan to avoid it, cash flow can be taxed twice. This double tax, sometimes totaling more than 50% of the total payout, can spell disaster for many internal

transfers. However, through effective tax planning, much of this tax burden can be legally avoided.

Finally, owners and their advisors, including a certified business appraiser, should use a modest but defensible valuation for the company. By using a lower value as the purchase price, the size of the tax will be correspondingly reduced. The difference between what owners will receive from the sale of the business at a lower price and what owners want to be paid after they leave the business is "made good" through a number of different techniques to extract cash from the company after the owner leaves it.

2. **Successors' management/ownership skills are untested**. If the successors' ownership skills are untested, owners should create a written plan to systematically transition management and ownership responsibilities to their successor(s), beginning today. The transition period, during which owners test both their assumptions and their successors' skills, usually takes several years to complete.

3. **Losing control before being cashed out**. This only happens if owners and their advisors fail to implement a transfer strategy designed to keep the owner in control until he or she receives the full sale price for the business. In a properly crafted plan, owners keep control through a well-designed and incremental sale of the company based on improving company cash flow over time.

There are four keys to reducing the risks of an insider transfer:

1. Plan the transfer well in advance of your desired exit date. Executing an insider transfer takes longer than executing a sale to a third party.
2. Implement value-building activities, which are just as—if not more—important to an insider transfer as they are to a sale to a third party.
3. Design the plan to be tax-sensitive.
4. Write the plan down and hold advisors accountable.

We have the experience and know-how to help you implement those keys and unlock the doors to your successful exit. Please contact us today to get started on your insider transfer today.

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