Legacy M&A Advisors LLC

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Four Paths to Business Succession

Bart A. Basi, CPA/Attorney at Law
The Center for Financial, Legal & Tax Planning, Inc.

Introduction

How are you going to end the relationship with your business? Believe it or not, that day will come. Fortunately, you have a number of options to plan your exit and watch your legacy continue. Four good, viable options exist to spin off your business. These options involve selling to family members, selling to a key employee, selling to a competitor, or selling to an investor. Business succession and exit planning are somewhat different in concept, but will be used synonymously for the purpose of this article. Though containing important differences, succession planning and exit planning will not necessarily be differentiated for this article.

1) Family Involvement

Family involvement is often the simplest form of business succession planning. Knowing your successor creates a level of trust. Because family members are often involved and familiar with a family business, they can be called upon to either take over or purchase the business. Rendering the business in one form or another to a family member is often emotionally fulfilling because the owner can see the business and its benefits on their own families. The transaction can generally be done through either sale or gift. However, selling the business to the next generation will eliminate many uncertainties that can occur with gifting.

2) Key Employees

Selling your business outside the family is an option as well. On the positive side, key employees know the business, employees, suppliers, and the customers. They may also know the company overall including bank accounts, the financial situation, the equipment the company owns, and for that matter where the files and keys are kept. The business essentially becomes their turn-key operation. However, problems do exist in business sales to key employees. First, some key employees make "great employees", but terrible bosses and business people.

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A CASE STUDY

CFO and Mental Health Issues

A Federal District Court has ruled that a CFO's mental issues were no excuse for the non-collection of a wage garnishment order for taxes. The CFO in the case had received a certified mailing from the IRS ordering him and the company to garnish and send a substantial amount of the wages of one employee in satisfaction of a tax debt to the IRS.

The CFO did not comply with the mailing and later left the company, not mentioning the order to anyone upon leaving. Eventually, the IRS took issue with the noncompliance and filed suit against the company. The two defenses available in such a case are lack of possession and lack of obligation to perform under the order of the IRS. The company showed neither and the company ended up paying the tax for not complying with the order.

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Cover Story

There is also the problem of financing. Many employees are not wealthy people. A lot of their wealth is in the form of retirement accounts and home ownership. With this financial structure, it is nearly impossible for them to get the full financing to take on the challenges of an acquisition. This often means the seller must finance the acquisition for the key employee. The seller must lend credit to the key employee to finance the purchase. On the upside of this, the owner retains an interest in the business for which he can retake the business if the key employee/buyer defaults.

3) Investors

An investor, for many smaller businesses is hard to come. Many investors are happy to invest money, but typically they are seeking companies established and operating similarly to a publically held company. Many or most smaller companies operate for the benefit of the owners' and their families making them a less attractive option for investors.

4) Competitors

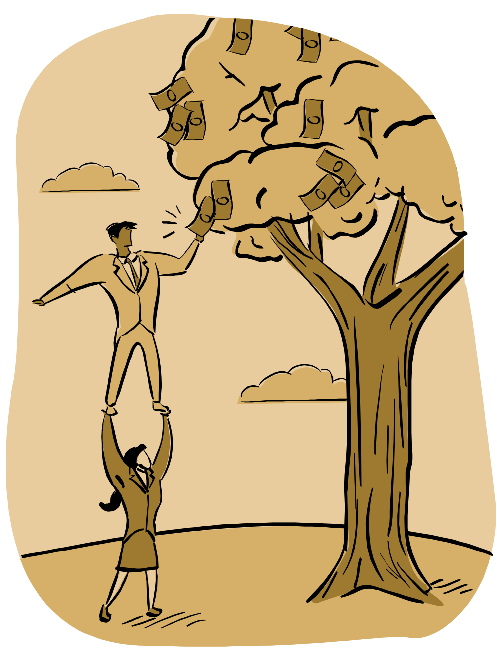
There is a clear advantage to selling a business to a competitor. Competitors generally know your suppliers and even your own customers on some level. Competitors also tend to have cash and liquid assets allowing them to be solvent and pay for things like other companies. On the down side, selling your life's work to a competitor or getting your business back in the event of a default can be impossible once it is combined with another operation.

Conclusion

Being aware of the possibilities concerning what type of successor you will have for your business can give you a clear vision of what your transition could look like. Not all people have families. Also, not every business has key employees who could take over the business. With the four options discussed above in mind, the business owner can now begin to think about implementing a succession plan.

Points of Interest

- **Four good, viable options exist to spin off your business.**
- **Rendering the business in one form or another to a family member is often emotionally fulfilling because the owner can see the business and its benefits on their own families.**
- **…selling your life's work to a competitor or getting your business back in the event of a default can be impossible once it is combined with another operation.**



Dr. Bart A. Basi is an attorney, CPA, and the Senior Advisor of The Center for Financial, Legal & Tax Planning, Inc, a full service company specializing in financial, legal & tax matters. Basi is a nationally recognized author, lecturer, and advisor on how to structure deals to minimize taxes. Tax structure makes the difference between getting the deal done and watching the deal fall apart. Many of you may be familiar with Basi and the topics he covers in the Financial, Legal & Tax Advisory which may be read in various industry-specific trade publications.

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A CASE STUDY CONTINUED:

Editor's Comment: It is easy to lose a piece of mail in an office, especially if an employee is chronically disorganized. In this case, the CFO of the company merely disregarded the order of the IRS. NOT GOOD from any standpoint! However, the CFO, being a responsible officer, was obligated to inform the company of the obligation. The company therefore had the obligation to act, which it did not. It is our recommendation that any IRS mailings received on behalf of an employee be sent to a responsible person. If you suspect issues with an employee, address them fast and deal with them quickly.

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HOW DOES GOODWILL CONTRIBUTE TO THE MARKET VALUE OF A BUSINESS?

In the real world of buying and selling businesses, some businesses have a very large component of goodwill, while others have little or none. The concept of goodwill is confusing to most business owners, and many hold serious misconceptions about how goodwill comes into play in valuing their business. If fact, many business owners believe that goodwill is somehow calculated from the years they've been in business, the cumulative effect of all their advertising, their long-term customer relationships, etc., which is then added to the value of all their tangible assets to arrive at the total market value.

Let's begin by reviewing two fundamental principles of business valuation. The first principle is that the market value of any ongoing business is fundamentally driven by the expected value of its future cash flows. This is what the buyer is willing to pay money for, i.e., the right to own the business' cash flow into the future.

Since so much time and attention is invested in gathering and analyzing historic cash flows it may appear to the business owner that the value of his/her business is being determined by its past cash flows. In reality, analyzing the recent past is perhaps the best way to truly understand the proven, cash flow generating capacity of the business, and its quality, predictability, volatility, and cyclicality, as well as the likelihood that it will continue into the foreseeable future.

Another fundamental principle of business valuation is that the minimum value of any ongoing business – even one that is currently losing money -- is at the market value of its tangible assets. Even if the owner decides to close the business, he/she should be able to collect the current accounts receivable and sell the inventory, equipment and other tangible assets at their current market value, depending upon how quickly it must be liquidated.

Goodwill is the accounting term given to the excess value of a business' future cash flow over the value of its tangible assets. Consequently, businesses which are losing money, or only marginally profitable, may only be worth the market value of their tangible assets, and have zero goodwill. In contrast, businesses that are profitable and earning a good to excellent return on their invested assets, will likely be worth much more than the market value of their tangible assets, and thus have very substantial goodwill.

If you know of someone who's thinking of selling or buying a business and who might benefit from a free, confidential, consultation, have them contact me directly at 813.299.7862, or mertel@lmaallc.com

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Frequently Asked Questions…

Q: I have yet to contribute to my IRA. When is the last day I can contribute funds to my IRA for the 2013 year?

A: Generally, funds contributed to an IRA must be contributed before the individual tax filing date for that particular year. For the 2013 tax year, April 15, 2014 is the deadline to file and make IRA contributions for 2013.

Q: I will end up owing taxes for the 2012 tax year. What can I do in order to reconcile the situation with the IRS?

A: There are a few avenues that can be taken. First, you can pay the bill in full. If the liability is too large you may file an installment agreement with the IRS to pay the debt over time. You can also apply your 2013 refund to the 2012 liability.

Q: What will the estate exemption be for 2014?

A: It is indexed for inflation is $5,340,000 for 2014. The annual gift tax exemption remains at $14,000.