ESTATE PLANNING

Sell Your Business and Create a Family Legacy

By: Paul Chmielewski

The sale of a business is often a study in contradictions.

The sale often represents the largest financial event in the business owner's life...

However, 75% of business owners later claim to have seller's remorse—that deep sense of regret of having sold their business. Seller's remorse appears to be correlated with lack of planning: 83% of selling owners do not have a formal transition plan, 67% do not understand all the sales options available to them, and only 4% have a formal "life after sale" plan.[1] Like anything else in life, without proper preparation, things rarely work out as expected.

Pre-Sale Planning

The focus of most business sellers is to obtain the maximum net sales proceeds. In order to accomplish that goal, a business owner must consider a variety of business, accounting, financial and tax issues. Some of these issues cannot be resolved overnight so it is often recommended to start planning several years prior to a sale, if possible.

- **MANAGEMENT.** A business that is dependent on the owner for success is less attractive to a buyer. The most valuable companies are those that have a good management team in place that can carry on after the sale closes.

- **ASSETS.** Assets that are not essential to an operating business will not maximize the company's value. Such assets should be sold off or distributed to a separate entity that will not be part of the sale. For example, it is common for business owners to own their office building or their manufacturing facility. The real estate may be valuable to the selling owner, but the buyer may consider real estate as a noncore business asset. If not already in a separate entity, the real estate can be transferred into a separate entity before closing the sale. The earlier this occurs, the higher comfort the buyer will have that the business performance numbers being evaluated during due diligence will not be adversely affected by the transfer of the nonessential asset.

- **FINANCIALS.** If company financials have not been prepared in accordance with commonly accepted accounting practices, it could adversely affect the value of the company. Financial metrics should also be regularly reviewed to help ensure the company is being properly managed. If the metrics do not compare favorably to industry standards, the seller might have to evaluate options such as customer or supplier diversification, expanding or decreasing product offerings, or management changes. Annual audits are also helpful to support the company's financial condition.

- **VALUATION.** Many business owners start the sales process with an idea of what their business is worth. Sometimes the selling owner underestimates the value of their business; other times they overestimate the value. The best way to get an idea of the company's true value is to obtain a valuation from a qualified business appraiser. If the valuation comes in lower than the business owner expected, the business owner can review the company's financials and business operations and develop a strategy to increase the company's value. The most common valuation models are income approach, market approach and cost/asset approach. For most operating businesses, the income approach, which analyzes the company's historical or projected earnings, will generally be used to provide the most accurate valuation.

- **DOCUMENTATION.** It is important to have key documentation assembled prior to the due diligence process. Common documents reviewed include bylaws, minutes, details of benefit plans, vendor agreements, maintenance contracts, leases and information regarding intangible assets (e.g., trademarks and patents).

- **TAX ISSUES.** The tax liability arising from the transaction must be considered. This involves a consideration of not just tax rates but also of how the company's business structure will affect tax liability. For example, C corporations are subject to two layers of taxation (at the corporate and shareholder level), but they may qualify for valuable tax breaks as qualified small business stock. Under certain circumstances, a sales transaction might also be structured to allocate personal goodwill to the seller to obtain capital gains treatment.

- **LIABILITY.** When a business owner decides to sell their business, they do not want to worry about retaining liability after closing. One of the biggest areas in which this arises is whether to structure the transaction as a stock sale or an asset purchase.

A seller generally prefers a stock sale because the buyer assumes the company's debts and liabilities. In a stock sale, the buyer may also be liable for claims arising before closing but asserted after closing. Hopefully, this type of issue can be identified during the due diligence phase but that is not always possible.

A buyer generally prefers an asset sale. In an asset sale, the buyer is simply buying the company's assets but is not taking over the company itself. That means no liabilities are being assumed except those that may directly relate to the assets being acquired. For example, if the assets are subject to UCC liens (claims against business assets under the Uniform Commercial Code), the buyer would take the assets subject to those liens or can require the seller to have those liens removed prior to closing. Liability from business operations, such as employment claims, would not be assumed by the buyer.

In addition to liability issues, the choice between a stock sale and an asset sale also has separate tax considerations that must be weighed.

Post-Sale Planning

As mentioned above, most owners focus on obtaining the highest possible sales price for their business, but few develop a formal plan for life after closing. Despite the term "post-closing," selling owners should not wait until after closing to address these issues. Instead, the best results occur when these issues are considered and planned for prior to closing. This is especially true for estate planning which can achieve substantial estate tax savings if planning is done years prior to a sale. Post-closing considerations can be broken down into the following three key areas.

- **LIFESTYLE.** Many people cite retirement as their ultimate goal but are not happy once they get there. Business owners are no different. The reason for the letdown is that people need to feel fulfilled. Very rarely do selling owners who sit around watching TV all day feel happy and satisfied. To prepare, business owners should think about what their life will look like after they sell their business. Do they want to start a different career, volunteer for a charity, play golf as much as possible, become babysitters for their grandchildren or travel more? Whatever the goal, it should be realistic and affordable based on the net post-sale funds.

- **FINANCIAL.** It is sometimes difficult for business owners, who are used to continually building their business and generating additional income from it, to become comfortable living off of investment income. If spending is not kept in check, it could lead to unpleasant consequences, no matter how much the sales price was for the business. It is surprising how often selling owners just look at the sales price and assume everything will be okay. Meeting with a financial planner who can generate an estimated cash flow based on the after-tax sales proceeds is recommended. The financial plan can also incorporate the new expenses that the selling owner will have to pay out of pocket rather than through their business. For example, if the business paid for country club dues, car expenses or the cost of maintaining an airplane, the effect of those expenses having to be borne personally by the selling owner after closing should be considered.

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Another aspect that can be considered by the financial plan is the selling owner's aspirational goals beyond standard living expenses. For instance, one client had the following aspirational goals, in order of preference: (i) buy a vacation house in Carmel, California, (ii) travel internationally twice a year, and (iii) if possible, establish an education fund for his grandchildren. The financial plan incorporated these aspirational goals and determined, even if a market downturn occurred, the client could easily fund them all. On the other hand, it is not unheard of to see very successful former business owners, especially those with expensive hobbies (car racing being one example), who have to cut spending and develop what they consider strict budgets because of overspending. A comprehensive financial plan can help avoid this unpleasant situation.

» **ESTATE PLANNING.** Many business owners work hard to build their business so they can leave a legacy for their family. The imposition of estate taxes at death is an impediment that has to be dealt with when trying to build a family legacy. If an owner sells their business but keeps all the proceeds (and future appreciation) in their estate, it simply creates an ever-increasing estate tax bill which, in turn, diminishes the assets available for the surviving family members. Fortunately, many estate planning strategies exist to circumvent the wealth depletion effect of estate taxes. These strategies are most effective when done early. Business owners are, however, notorious for focusing all their time and energy on building and managing their business. Where does estate planning fall in the planning process? Unfortunately, the reality is that estate planning sometimes falls by the wayside until the best estate tax savings opportunities have passed. The good news is that although some valuable estate planning opportunities may have passed, it is rarely too late to implement a successful estate plan that results in a multigenerational family legacy.

Assess the Current Estate Tax Situation

The current estate tax exclusion amount is $12.92 million per person, which means up to $12.92 million of a person's estate is excluded from estate tax when they die. The estate tax exclusion amount is scheduled to increase annually through 2025. In 2026, however, the estate tax exclusion is scheduled to decrease to approximately $7 million. The maximum estate tax rate is 40%.

The current annual gift tax exclusion amount is $17,000 per recipient. That means a person can gift up to $17,000 to any number of persons they desire without incurring any gift tax liability. Any gifted amounts that do not qualify for the annual gift tax exclusion are taxable gifts. Taxable gifts are first applied against a person's estate tax exclusion amount. Once that is used up, then the gifting party may have to make a gift tax payment to the IRS. For example, if an individual gifts $12.937 million to their child this year, the first $17,000 will be a nontaxable gift under the annual gift tax exclusion amount. The remaining $12.92 million will be considered a taxable gift but it will simply be deducted from the gifting party's estate tax exclusion amount, meaning no out-of-pocket gift tax payment will be required. At death, however, the gifting party will no longer have any estate tax exclusion left so any assets in their estate will be subject to estate tax.

Generation-skipping transfer tax ("GSTT") is imposed on wealth transfers that attempt to skip a generation. For example, if a person maintains assets in a trust for the lives of their children and then distributes the remaining trust assets to their grandchildren, GSST will be imposed on distributions to the grandchildren. The GSST exemption amount is currently the same as the estate tax exclusion amount ($12.92 million) and it is scheduled to decrease in 2026 as well.

GIFT EARLY

For persons who can afford it, the scheduled drop in the estate tax exclusion amount in 2026 provides the ability to take an additional $5.92 million out of your estate now by gifting assets. This is possible because of the IRS's no-clawback rule. The no-clawback rule states that if someone gifts assets now (while the exclusion amount is $12.92 million) but then dies in 2026, when the estate tax exclusion is scheduled to decrease to approximately $7 million, the excess gift of $5.92 million will not be "clawed back" into the decedent's estate for estate tax purposes.

At a 40% estate tax rate, the savings obtained by simply gifting assets now rather than waiting until 2026 or thereafter would be approximately $2.4 million ($4.8 million for a married couple who both make gifts). If the gifted assets turn out to be a highly appreciating business interest, the estate tax savings is even greater because all future appreciation in the gifted asset also escapes estate tax.

USE VALUATION DISCOUNTS

When gifting closely held business interests, valuation discounts are often available for lack of control and lack of marketability, as gifted minority ownership interests tend to have a lower value than outright ownership in the assets. Let's assume a 25% discount is applied. That means an interest worth $16 million can be gifted using up only $12 million of an individual's estate tax exemption amount. In this example, the discount alone, saves an additional $1.6 million in estate tax savings assuming a 40% estate tax rate. Once a letter of intent (LOI) is signed for the sale of a business, the ability to transfer assets at low valuations is limited so, again, early planning is key.

COMMONLY USED ESTATE PLANNING STRATEGIES

Several common strategies are used to create family legacies with family business interests. Gifting and valuation discounts are often used in conjunction with these strategies.

Strategy 1: Grantor Retained Annuity Trusts (GRATs)

GRATs are estate planning tools that allow a business owner to gift business interests to the GRAT, often without using any gift/estate tax exemption amounts. The GRAT pays back the gifted amount plus interest, in the form of an IRS determined rate (Section 7520 interest rate), to the business owner over a fixed term. Any growth in excess of the 7520 rate remains in the trust at the end of the payback term. GRATs are referred to as an "estate freeze" strategy because they take future appreciation out of the business owner's estate. Because GRATs are often zeroed out for estate tax purposes, they do not result in any adverse gift/estate tax consequences, even if the strategy does not work. That means, if a GRAT doesn't provide enough growth to take assets out of the business owner's estate during the GRAT term, another GRAT can then be created that will hopefully achieve the desired estate tax benefits. Unlike SLATs and dynasty trusts, GRATs are not efficient for GSTT planning.

Strategy 2: Charitable Remainder Trusts (CRTs)

When a business owner gifts interests in their business to a CRT, the business owner receives an income stream from the trust for a term of years or for life. The assets remaining in the CRT at the end of the trust term go to charity. The business owner receives an immediate income tax charitable deduction when the CRT is funded based on the present value of the assets that will eventually go to the named charity. If a business owner contributes a business interest that is later sold, no income tax will be owed on the portion owned by the CRT. That will increase the asset base on which income is paid to the business owner. The additional income generated by the CRT tax savings is sometimes used to purchase a life insurance policy owned by an irrevocable trust. At the selling owner's death, this policy passes free of income and estate tax to the business owner's family to replace the wealth passing from the CRT to charity. It is important to contribute business interests to a CRT before an LOI is signed for the sale of the business. CRTs are more effective in a rising interest rate environment, such as the one we are now experiencing.

Strategy 3: Spousal Lifetime Access Trusts (SLATs) and Dynasty Trust

SLATs are often created as a form of dynasty trusts. Dynasty trusts allow for multigenerational wealth transfer. Both SLATs and dynasty trusts use up all or part of a business owner's estate tax exemption amount now rather than waiting until the owner's death. This allows assets to accumulate, grow and pass free from estate tax and GSTT for multiple generations. The difference is that a SLAT also allows the gifting individual's spouse to benefit from the SLAT while they are alive without the assets being included in the spouse's estate. This allows the gifting business owner to indirectly benefit from the gifted asset while their spouse is alive. The no-clawback rule makes SLATs and dynasty trusts valuable estate planning strategies to consider now.

Strategy 4: Intentionally Defective Grantor Trusts (IDGTs)

IDGTs are also an estate-freeze technique. The business owner sells a business interest to the trust in exchange for a promissory note using an IRS prescribed interest rate (the applicable federal rate or AFR). The growth in excess of the AFR rate escapes estate tax. The AFR rate used for IDGTs is usually lower than the Section 7520 rate used for GRATs. GSTT planning can also be done efficiently with IDGTs. IDGTs, however, generally require a "seed gift" of 10% of the asset being purchased, which will use up some of the business owner's gift/estate tax exemption.

Plan as Early as Possible

Although maximizing the sale price of an owner's business is important, planning should not stop there. Incorporating financial, tax and estate planning can help prevent seller's remorse and ensure financial security for multiple family generations. The likelihood of success increases with early planning.

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If you have questions on estate planning and selling your business, contact a Cerity Partners advisor. Contact Us

[1] Statistics provided by the Exit Planning Institute's "The State of Owner Readiness Survey 2013 National Survey Final Report," 2013.

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