PNC CENTER FOR FINANCIAL INSIGHT

PNC Center for Financial Insight[SM] builds bridges from thought to action, creating practical, applicable strategies to help benefit you and your family.

Planning for the Transition of Your Business

A fully developed exit plan can help you reap the rewards of all the hard work you put into your business and provide numerous benefits well in advance of a transition.

Exiting your business without a well thought-out succession plan is like entering a Formula One race without knowledge of the track. You may cross the succession finish line, but without thorough planning, you likely won't take the checkered flag.

A well-designed exit plan can facilitate a number of goals — in some cases well in advance of the transition itself. A detailed plan can help:

- maximize the value of your business;
- control the timing of your exit;
- reduce exposure to litigation risk post-transfer;
- create opportunities for key management;
- create incentives for employees;
- keep the family business in the family;
- develop an effective retirement plan;
- avoid family conflict; and
- fulfill your philanthropic goals.

As with many things in life, it is common to begin on one path and end on another. Exit planning can position you and your business for an optimal transition — whether you have a clear goal, are at a unique crossroads in your business, or even if you have not yet begun to weigh succession.

Begin with the Destination

The first step in exit planning is to clearly articulate, understand, and prioritize your goals. The next step is to clarify what it is you seek to accomplish through the business succession planning process. These steps can help you develop your transition plan.

Exiting Your Business

There are three common methods of exiting a business: a sale to a third-party buyer, a transfer to employees, and a transfer to family members. Each of these methods involves different considerations and may yield different benefits.

Maximizing Business Valuation

The most common form of business transition is a sale to a third party. One key factor in this type of sale is positioning the business to obtain the highest valuation. A potential buyer will go through a due diligence process that involves examining the business, including its operations, history, property, employees, financials, documentation and legal matters. Working with a team of advisors to understand the factors a buyer may consider and how to address and improve those factors within your company can help to drive the value of your business higher. The following are just a few examples of value-drivers a buyer may desire:

- stable and predictable cash flows;
- a strong customer base that is well established, reliable, and diverse;

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- documented growth potential;
- barriers to entry into industry, for example, patents, copyrights, trade secrets, and licenses;
- goodwill, for instance, a company built on a strong reputation and with brand-name recognition;
- diverse product and service offerings;
- human capital, including employee institutional knowledge and experience; and
- appropriate company policies and procedures.

Having a strong, well-established management team may be an especially desired value driver. Buyers may want to see that there are agreements in place to retain key employees. This can come in the form of employment agreements, non-compete agreements, or compensation arrangements that provide employees incentive for remaining with the business after a change of ownership. See "A Strategic Approach to Attracting and Retaining Key Employees," produced by the PNC Center for Financial Insight, for additional details on executive compensation arrangements.

Controlling Exit Timing

Having a well thought out business succession plan can provide a greater level of control over your continued involvement in the business and the timing of your exit. It can help you determine how flexible you are willing to be and the importance of your timing compared to other goals.

For example, if your goal is to remove yourself from active management and employment in the business immediately upon completion of the transfer, having a strong management team in place can help facilitate your exit. Otherwise, a third-party buyer may require you to remain involved with the company for a period of time under an employment contract or independent contractor agreement.

Steps such as organizing the business financials, locating and updating relevant organizational documents, and conducting necessary maintenance on equipment and property can mean the difference between exiting the company in a timeframe close to your choosing or having to push your exit back a number of years.

Alternatively, if you transfer the business to family or employees, you may want to reserve the right to step back into the business. Such a provision in the sale agreement is often referred to as a buy-back right. Including such a right may provide a comfort level which allows you to transition out of the business when you want, knowing you could return to an ownership position if needed. Buy-back rights can help to protect the seller's financial interest in the ongoing success of the business.

Reducing Post-Sale Litigation Risk

Business owners often accept a level of risk in order to pursue financial rewards. It comes with the territory if your goal is to build, grow, and operate a business. Your risk appetite post-sale, however, may be quite different than pre-sale.

How you transition out of business ownership can greatly affect your post-sale litigation risk. This could be a key consideration in determining whether to structure the sale of your business as a stock sale or an asset sale. In a stock sale, the buyer steps into the shoes of the previous owner, allowing the seller to walk away from potential claims and obligations. You may, however, not be able to sell the business via a transfer of stock.

Depending on the nature of your business, potential buyers may want to purchase the assets of your business. In any event, a clear understanding of the agreement including the covenants, representations, and warranties and their respective applications and limitations is critical to minimizing the risk of adverse claims.

You may wish to transition the business to the employees who have helped you grow the business to what it is today. This may be accomplished through a sale to a group of key management or through selling the business to an Employee Stock Ownership Plan (ESOP).[1]

Creating Opportunities for Key Management

One advantage of a key management buyout is that the buyers will be intimately familiar with business operations and financials, which can make the due diligence process less onerous. They would presumably also remain in their current roles. This would provide a level of stability for customers, suppliers, and other employees and increase the likelihood of continuing business success.

Key management is unlikely to have the funds necessary to acquire the business in a cash sale. Typically such a sale will require the management group to finance the buyout by taking on debt. The terms of the sale will also most likely involve an installment sale with payments paid out over a period of years, underscoring the need to work toward the future success of the business. As noted above, this could affect the timing of your exit.

Creating Employee Incentives

You may wish for all employees to benefit rather than just a few key employees. If this is the case, an ESOP may be a viable alternative. An ESOP is a qualified retirement plan uniquely designed to invest primarily in the stock of the sponsoring company. The plan is also permitted to borrow funds, enabling it to acquire the stock. As participants in the ESOP, employees of the business benefit from the growth in company stock, providing a financial incentive linked to company success.

Selling a business to an ESOP may provide a number of tax advantages and provides a means for liquidating the business expeditiously. An ESOP is also a potential alternative for owners who do not intend to transfer the business to family members and have limited options for selling to a third party.[2]

Keeping the Business in the Family

If your goal is to keep the business in the family, gifting (rather than selling) all or a portion of the business may be an option. Two key factors in making this decision are the federal gift tax, currently levied at a rate of 40%, and your own personal cash flow needs after the transition. The Tax Cuts and Jobs Act of 2017 raised the gift and estate tax exemption to $11.18 million ($22.36 million for married couples) through the year 2025. Under current tax law, the exemption is set to reduce by approximately half in 2026. This provides a window of opportunity to

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[1] Refer to the article, “How to Optimize your Business Succession Planning with an ESOP” produced by PNC ESOP Solutions. Available at https://www.pnc.com/content/dam/pnc-ideas/articles/ESOP-Insights-2Q-18.pdf.

[2] Refer to the article, “Understanding ESOPs as an Ownership Transition Alternative” produced by PNC ESOP Solutions. Available at https://www.pnc.com/content/dam/pnc-ideas/articles/CIB_UNDERSTANDING-ESOPS.pdf.

make lifetime gifts of a family business interest while avoiding gift taxes.

Factors such as the desire, experience, and aptitude of the family members to run the business should also be considered as early in the process as possible. Bringing children or other family members into the business gradually so they can learn the ropes and prepare themselves for leadership is a best practice. One strategy to accomplish this is to transfer non-voting interests in the business first, while retaining voting interests and control until the younger generation gains experience and proves themselves. Such transfers reduce the exposure to estate tax by effectively transferring the future appreciation of the business to the next generation.

Developing an Effective Retirement Plan

It is important to work with your financial advisors to determine how much of the business you can afford to gift without jeopardizing your desired post-exit lifestyle. Allowing for the financial needs of the business owner to be adequately met can be a fundamental component of good planning. An alternative is for the transition to be a partial gift and partial sale, depending on the level of cash flow needed to meet your financial goals post-transition.

Avoiding Family Conflict

Parents may consider transferring equal ownership to all their children, regardless of their involvement in the business. But the potential for conflict among active and non-active children can be substantial. For example, if there is a year when the business needs to retain profits in order to pursue a business opportunity, the children who are not active in the business but have grown accustomed to receiving dividends may be at odds with their siblings who are active in the business. It may be better to avoid giving an ownership interest to children who are not actively participating in the business.

A potential solution when multiple children are involved, some active and some not, is to separate the real property from the business. This would allow the business owner to gift or sell the real property to the non-active child and gift or sell the business to the active child. Prior to the gift or sale, the business could enter into a long-term lease agreement to avoid conflict between siblings after the transfers.

If your intention is to retain ownership of the business and pass it on to your children at death, consider passing on the business to children who are active in the business and equalizing non-active children with other assets. One simple way to accomplish this is to acquire life insurance and name the non-active children as beneficiaries.

Fulfilling Philanthropic Goals

When a business owner starts down the path of succession planning, it is important to do so in a comprehensive manner that considers financial goals beyond transitioning out of the business. In some cases, your exit strategy may accomplish multiple objectives. There may be opportunities to achieve your business succession goals and philanthropic goals all in one transaction.

Instead of selling the business directly to the buyer, the ownership interest may be contributed to a specially designed split interest charitable trust that provides income to the donor and a remainder interest to a named charitable organization. Refer to the article, "Charitable Remainder Trusts" produced by the PNC Center for Financial Insight, for additional details on Charitable Remainder Trusts. This will provide the business owner/donor with an income stream, a charitable income tax deduction, and a deferral of the capital gain. The buyer can purchase the business interest from the trust. At the termination of the trust, the remainder in the trust will be transferred to charitable organizations designated by the donor. This strategy is not available to S corporations[3] and is most appropriate for those who need the income and have a charitable intent. In order to obtain the tax benefits mentioned, there may be no preexisting obligation for the trust to sell the business interest to the buyer.

Business succession planning is often a very involved and complex undertaking. Achieving your goals often requires balancing different priorities that are often at cross purposes. However, through deliberate planning that incorporates your unique goals, needs, and characteristics, you can set yourself up for ultimate success.

[3] S corporations are those that pass corporate income, losses, deductions, and credits through to their shareholders for federal tax purposes. See www.irs.gov/business/small-businesses-self-employed/s-corporations.

For more information, please contact your Hawthorn advisor.