How to Exit your Business Without Getting Clobbered by Taxes: Different Paths, Values and Taxes

Exiting Your Business Without Being Clobbered by Taxes

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COO

This session is eligible for 1.5 Continuing Education Hours.

To earn these hours you must:
- Have your badge scanned in and out at the door
- Attend 90% of this presentation
- Fill out the online evaluation for this session
Overview

• Kevin’s Company Story – Success & mistakes not to make
• Overview of exit planning

Joe Bazzano

- Steps in the exit planning process
- Different paths, values, taxes
- Case study

Introduction

Owner

- Emotional
- Intimidating
- Taxing

Teacher

- Complex
- Understandable

Big Picture

- 70% Wealth
- Taxes
- 0-50% +

Objective

- Calculate Number
- Identify 5 Paths
- Measure 5 Values
Kevin’s Story

“Could not see the forest for the trees”

6 YEARS LATER
AND
$250,000
Our Problem

- Reactive
- Not understanding our options
- Three owners with different goals
- Isolated
- Advisers’ bias
- Different towers
- Advisers not communicating
- Successful operators
- Doing it for the first time
- Risk

December 31, 2008

- Built a third succession team
- Fourth generation
- One Percent
Odds Are Against You!

Family Firm Institute Study

**Internal Transfers**

- **70%** Fail to transfer into second generation
- **90%** Fail to transfer into third generation

**U.S. Chamber of Commerce**

**External Transfers**

- **20%** Businesses brought to market actually sell
Six Exiting Myths

“I will sell my business to a consolidator or competitor”

“I will sell my business to my employees, managers or family”

“My business is worth $12 million.”

“If I could get $8 million, I would retire tomorrow.”

“But that will never happen to me.”

*Death, Divorce, Disease, Disability, Departure*

“But my accountant does exit planning.”

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You Don’t Know....

What You Don’t Know
It Could Save You Millions

Architect

For Reference of NECA Now 2015
Attendees Only
Exit Planner

Joseph Bazzano
COO

Beacon Exit Planning, LLC
What’s Really Important?

Your Most Valuable Asset

Five Major Pitfalls For Business Owners

- Unrealistic Valuations
- Improperly Documented Buy/Sell Agreements
- Litigation/Asset Protection
- Tax Planning
- Succession Planning

For Reference of NECA Now 2015
Attendees Only
Three Main Areas of Focus

- Business
  - Valuation
  - Succession
  - Taxes
  - Transfer options
  - Litigation

- Personal
  - Emotional ties to business
  - Family members
  - Legacy

- Financial
  - Outliving your money
  - Protection for spouse and family
  - Asset insulation
  - Taxes

Much of this planning may have already been addressed by advisors

Who is coordinating the circles to help you meet your exiting goals?
What Will You Need to Consider in Your Business Transition?

In the next section we will identify the steps that YOU should consider when planning your exit.

BEST PATH

- Blueprint
- Emotions
- Substituting Your Income
- Taxes
- Possibilities
- Appraisals
- Tactics
- Happiness
An exit plan is a Blueprint that will COORDINATE all the relevant components of your life and DIRECT you towards the common goal of exiting your business, on your terms, and PROTECT the wealth that you have accumulated.

Every business owner has emotional ties to the business. It’s not just what you do but who you are!
BEST PATH

Substituting Your Income

- How much money do I need from the business to replace my income?
- Will my liquid assets be sufficient to generate the income that I need?
- Single greatest obstacle for taking action – “Fear of outliving my money!”
TAXES

Sales (5-8%)
Income (0-39.6%)
Capital Gain (0-23.8%)
Corporate (15-34%)
Payroll (8-10%)
Estate/Death (0-40%)

*Don’t Forget State / Local Taxes

Additional Chunk Goes to State
0% to 13.3%
Three Parties to Every Transaction:
• Seller
• Buyer
• Uncle Sam

Government’s share can be as low as zero percent to over 60%

Why?
• Entity formation
• Deal structure
• Exit method
• Tools of the trade
Based on the goals that you have determined are important to you, there are several exit possibilities and paths available to you and each will have varying degrees of tax ramifications.

1. Sale of the Business (SALE)
2. Private Equity Group Recapitalizations (PEG)
3. Employee Stock Ownership Plans (ESOPs)
4. Management Buyouts (MBO)
5. Gifting Programs (GIFTING)
Internal Transfers or External Transfers

- Employee Stock Ownership Plans
- Management Buyout
- Gifting
- Recapitalization
- Sale to an Outside Buyer

BEST PATH

Appraisals
Do you know how much your business is worth?

It has different values based on the path you choose

We call it a range of values
Range of Values

- Owner’s Perceived Value → Unrealistic Value
- Sale to an Outside Buyer → Strategic/Synergy Value
- Recapitalization → Investment Value
- Management Buyout → Investment Value (structured)
- Employee Stock Ownership Plans → Fair-Market Value
- Gifting → Fair-Market Value

The Only Formula You Need to Know!

\[ V = CF \frac{S}{T} x MM +/- BSA \]

- \( V \) = Value
- \( CF \) = Cash Flow
- \( S \) = Sustainable
- \( T \) = Transferable
- \( MM \) = Market Multiple
- \( BSA \) = Balance Sheet Adjustments
“Distractions Hurt Value”

The reality is that many business owners are too distracted to implement value drivers

BEWARE OF INDUSTRY MULTIPLES

Timing, Timing, Timing

Ten Year Private Transfer Cycle

1980 1990 2000
1983 1993 2003
1990 2000 2010

- Distractions Hurt Value
- Quality of Earnings
- Gross Margins
- Recurring Revenue
- Management
- Customer Composition
- Reputation
- BEWARE OF INDUSTRY MULTIPLES

• Timing - timing - timing
• Ten year cycles
• Pattern indicates next window 2013 - 2018

By Rob Slee, Private Capital Markets
Factors to Consider

**Valuation**
- Cash Flow
- Risk
- Debt
- People/IP
- Economy
- Taxes
- Industry/Competition
- Exit Method

Which Tactics will you employ to get you through the “Red Zone”?

Understanding and coordinating the various moving parts is critical to the success of your business transition.

A well thought out, properly written plan will guide you towards your ultimate goal........
Happiness can only be achieved when your goals have been identified and the plan that you created comes to fruition.

Case Study
Concentration of Wealth

<table>
<thead>
<tr>
<th>Category</th>
<th>Value</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Business</td>
<td>$8,670,000</td>
<td>66%</td>
</tr>
<tr>
<td>Savings</td>
<td>$2,000,000</td>
<td>15%</td>
</tr>
<tr>
<td>Real Estate</td>
<td>$2,466,000</td>
<td>19%</td>
</tr>
</tbody>
</table>

Financial Readiness

Steve and Susan estimate their annual lifestyle needs equate to approximately $675,000. These include:

- Wages (pre-tax) $450,000
- Expenses paid through the business $225,000
- Total Required Income $675,000

- Vehicle/hobbies $40,000
- Meal, travel & entertainment $40,000
- Spousal/family expenses (benefits) $5,000
- Total after-tax $135,000
- Total pre-tax $225,000
Financial Readiness

- Total Required Income: $675,000
- Other sources of income:
  - Retirement: $60,000
  - Rental: $260,000

INCOME TO BE REPLACED: $355,000

Current Savings Outside of the Business Include:
- Cash in Checking Account: $125,000
- Marketable Securities: $975,000
- Retirement Savings: $900,000

Total Savings: $2,000,000

Asset Base Required: $355,000 / 5% = $7,100,000

Value Gap: $7,100,000 - $2,000,000 = $5,100,000
Application to Exit Strategies
Range of Values

- Sale to an Outside Buyer: $11,000,000
- Recapitalization: $8,000,000
- Management Buyout: $8,000,000
- Employee Stock Ownership Plans*: $7,500,000
- Gifting*: $7,000,000

*TMS Rev. Rul. 59-60: Indicates requirements that need to be included in fair-market value valuations

TACTICS

There’s more than one way to skin a cat
Tools of Our Trade

- IRC - Sections
  - 179/338/1060/1202/1042/1045
- Individual Insurance Companies
- S Corporation ESOPs
- Special Trusts
- Cost Basis Consequences
- Synthetic Equity
- Entity Structures

Tools in Action

Use trust to reduce estate taxes and eliminate capital gains.

Insurance company can prefund exit using ordinary deduction at corporate level - recognize capital gain upon distribution and equalize ownership.

Receive cash from successor on a tax efficient basis.
### Summary of Methods - External Sale

<table>
<thead>
<tr>
<th></th>
<th>C Corporation</th>
<th>S Corporation</th>
</tr>
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<tbody>
<tr>
<td></td>
<td>Asset Sale</td>
<td>Stock Sale</td>
</tr>
<tr>
<td>Proceeds to/from buyer</td>
<td>$11,000,000</td>
<td>$8,000,000</td>
</tr>
<tr>
<td>Taxes paid</td>
<td>(3,024,000)</td>
<td>-</td>
</tr>
<tr>
<td>Liabilities paid</td>
<td>(3,000,000)</td>
<td>-</td>
</tr>
<tr>
<td>Fees paid 4%</td>
<td>(440,000)</td>
<td>(320,000)</td>
</tr>
<tr>
<td>Proceeds to seller</td>
<td>4,536,000</td>
<td>7,680,000</td>
</tr>
<tr>
<td>Capital gain on sale of stock</td>
<td>4,535,000</td>
<td>7,679,000</td>
</tr>
<tr>
<td>Cap gains paid by seller - 29.8%***</td>
<td>(1,351,430)</td>
<td>(2,288,342)</td>
</tr>
<tr>
<td><strong>Net Proceeds to Sellers</strong></td>
<td><strong>$3,184,570</strong></td>
<td><strong>$5,391,658</strong></td>
</tr>
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</table>

**Recap**

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<td>$7,815,430</td>
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**Effective Rate of Proceed Erosion**

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<th>S Corporation</th>
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<tr>
<td></td>
<td>71.05%</td>
<td>32.60%</td>
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*Assume stock basis in C corporation is $1,000
**Assume stock basis in S corporation is $250,000
***Assume asset basis as follows:

<table>
<thead>
<tr>
<th>Basis</th>
<th>FMV</th>
<th>Liabilities</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fixed Assets</td>
<td>$2,500,000</td>
<td>$5,000,000</td>
</tr>
<tr>
<td>Inventory</td>
<td>500,000</td>
<td>500,000</td>
</tr>
</tbody>
</table>

### Summary of Methods - Internal Sale

<table>
<thead>
<tr>
<th></th>
<th>Bonus</th>
<th>ESOP**</th>
<th>Redemption</th>
<th>Plan</th>
</tr>
</thead>
<tbody>
<tr>
<td>Proceeds to/from buyer</td>
<td>$15,473,676</td>
<td>$7,500,000</td>
<td>$13,333,333</td>
<td>$13,333,333</td>
</tr>
<tr>
<td>Taxes paid</td>
<td>(7,473,676)</td>
<td>-</td>
<td>(5,333,333)</td>
<td>(5,333,333)</td>
</tr>
<tr>
<td>Fees paid 5%</td>
<td>(200,000)</td>
<td>(125,000)</td>
<td>(20,000)</td>
<td>(25,000)</td>
</tr>
<tr>
<td>Proceeds to seller (ESOP FMV)</td>
<td>7,980,000</td>
<td>7,375,000</td>
<td>7,980,000</td>
<td>7,975,000</td>
</tr>
<tr>
<td>Basis in Stock</td>
<td>(1,250,000)</td>
<td>(1,250,000)</td>
<td>(1,250,000)</td>
<td>(1,250,000)</td>
</tr>
<tr>
<td>Capital gain on sale of stock</td>
<td>6,730,000</td>
<td>6,125,000</td>
<td>6,730,000</td>
<td>6,725,000</td>
</tr>
<tr>
<td>Cap gains paid by seller - 29.8%***</td>
<td>(2,005,540)</td>
<td>(1,825,250)</td>
<td>(2,005,540)</td>
<td>-</td>
</tr>
<tr>
<td><strong>Net Proceeds to Sellers</strong></td>
<td><strong>$5,974,460</strong></td>
<td><strong>$5,549,750</strong></td>
<td><strong>$5,974,460</strong></td>
<td><strong>$7,975,000</strong></td>
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<td>$13,333,333</td>
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</tr>
<tr>
<td>Taxes and Fees Paid</td>
<td>$9,499,216</td>
<td>367,500</td>
<td>7,358,873</td>
<td>5,358,333</td>
</tr>
<tr>
<td><strong>Net</strong></td>
<td><strong>$5,974,460</strong></td>
<td><strong>$7,007,500</strong></td>
<td><strong>$5,974,460</strong></td>
<td><strong>$7,975,000</strong></td>
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<td>61.39%</td>
<td>4.98%</td>
</tr>
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*Section 338 Election eliminates gain at corporate level - eliminates BIG tax
**Utilizing 1042 rollover - no taxes to seller
***Utilizing Corporate Distribution codes sections eliminated Cap Gain
Summary of Methods

The results could be surprising…

“The question is what’s it going to cost you?”

Questions

Up Next: Interactive Break in the Mezzanine

- Taking Your Company’s Safety Training to the Next Level: Augmented Reality
- It is Not How Much Money You Get, but How Much Money You Keep
- Verizon M2M-Wireless Hub
- How to navigate necanet.org
- Profile of the Electrical Contractor