

The EXIT Planner

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WHAT'S INSIDE

by John H. Brown
President, Business Enterprise Institute, Inc.



→ JOHN H. BROWN

BENJAMIN FRANKLIN: EXIT PLANNER EXTRAORDINAIRE

There is a strong connection between business planning, the subject matter of this issue of *The Exit Planner*, and exit planning itself. Indeed, as Barbara Wells points out in her article, business planning, in many ways, is just a preliminary stage of exit planning.

Benjamin Franklin said it best: "An ounce of prevention is worth a pound of cure." In this case, owners need to design and to conduct their business activities to avoid and minimize liability and adverse tax consequences. The owner must be aware of liability issues and tax consequences that arise *during* the course of business and those which rear their ugly heads only upon the *imminent sale* of that business.

This type of prevention is best achieved by practicing "business planning" as described in this article. Preventing problems such as operating your business within the wrong entity form can save untold taxes when it comes time to exit your business. Working to ensure continuity in case of your early demise and estate planning for the good of your family may not be fun but they are necessary to maintain business value in the face of the unforeseen.

Business planning, however, is not merely preventative but is also proactive in that it can increase the value of your company. One of the best ways of doing so, as described in this article, is to adopt key employee incentive plans; plans that are designed to motivate and to keep your key employees. Without your employees you will likely have no business at all.

If your exit strategy is designed to allow you to leave the business more than two or three years into the future, or if you have no exit strategy formulated at this point, this article is a "must read." Beginning the business planning process earlier will lead to greater business value as well as give you time to tie up loose ends. Remember, as that great business planner once said, "A stitch in time saves nine."



PRESERVE AND INCREASE BUSINESS VALUE THROUGH BUSINESS PLANNING

By Barbara J. Wells

“Business Planning” is a shorthand way of describing activities that are designed to preserve and enhance the value of a business. Business owners actively planning for the day that they will sell or transfer their businesses and those “simply” working to grow more profitable all benefit from business planning.

True business planning is the periodic review of a number of key issues which affect the short term profitability and long term value of a company. In this context, “periodic” means at least annual and, at best, quarterly meetings of the business owner and his or her advisors. Business Planning should not be confused with a “Business Plan” which basically describes the practical and financial plans for the business. Business Planning is both a basis for the Business Plan and a method by which the plan is carried out. In my law firm, we use several Business Planning strategies to protect and to increase business value. These include:

- Examining form of business entity;
- Identifying possible problem areas;
- Motivating and rewarding key employees;
- Ensuring continuity; and
- Estate Planning for the business owner.

There are, of course, other issues which can arise in good business planning, and the advisors at the annual or quarterly meeting should keep their ears tuned to other needs of the business owner as well.

RE-EXAMINING FORM OF BUSINESS ENTITY

With the assistance of your advisory team, (your CPA, attorney and insurance advisor or financial planner) you should periodically review the form of entity under which you operate your business. The form of business entity determines three key items in the effort to preserve and increase value. They are:

- The tax consequences of daily and annual operations;
- The liability protection afforded; and
- The tax consequences upon the eventual disposition (sale) of your business.

The forms of entity under which you may operate include: the regular or “C” corporation, the “S” corporation, the limited liability corporation or limited liability partnership, and the sole proprietorship. Let’s look quickly at each in light of current tax consequences, liability protection and tax consequences upon sale.



→ **BARBARA J. WELLS**

Current Tax Implications

In a regular corporation, the corporation pays the taxes and is given the advantage of progressive rates so that the first dollars are taxed at a lower rate, thus saving overall taxes each year. There is a trade off, however, in that there may be more taxes due upon dividend payments and/or on the eventual sale or liquidation of the business than there would be using another form.

In an “S” corporation, there is no corporate tax—all taxable income is included in the shareholders’ personal tax returns. A short term disadvantage is that the lower tax rates available to a regular corporation are unavailable in the “S” corporation. On the other hand, if the business loses money and that money is provided by the business owner, the business owner can use these tax losses to offset income from other sources. Further, upon the eventual sale of the business the overall taxes may well be lower than in a regular corporation.

There is no tax either on a limited liability company or a partnership and, as noted above for the “S” corporation shareholders, the owners of the limited liability company or partnership will be taxed on all of the business income

with no ability to take advantage of lower rates on the initial dollars. The tax situation on the sale of the business is also similar to that for an “S” corporation. Further, there are two significant tax advantages in using a limited liability company or a partnership. First, the business owner may be able to claim deductions for business losses even if the company, rather than the business owner, borrowed money that was used to pay expenses and generated these deductions. Second, if the business is simply liquidated and the assets passed out to the owners, there generally is no “deemed sale” of the property due to that distribution and thus no immediate tax liability. The owners take title to the property and defer taxes until the property is actually sold.

On the other hand, if a corporation (regular or “S”) simply distributes assets to its shareholders, the company is deemed to have sold the assets, thus resulting in a tax liability based on the fair market value of the asset even though no cash is available from a real sale to pay the tax.

Of course, nothing is perfect and there are some tax disadvantages to using the limited liability company or partnership form. For example, there are complicated rules regarding how the owners will be taxed. If the partnership or operating agreement does not follow these rules, an owner can be taxed on income that he does not have any right to receive. These rules were put in place in part to prevent owners from avoiding tax by allocating the taxable income to an owner in a lower tax bracket. However, they can be a trap for the unwary who inadvertently violate the complicated tax rules.

A sole proprietorship is simply a business which you operate personally. There is no entity to tax. All profits and losses are taxed to the business owner because all assets are actually owned by the business owner personally.

Note that one planning technique is to combine these forms. For example, you can use a “C” or an “S” corporation for that part of the business which conducts operations and an LLC to own the assets and act as a leasing company. This is the type of planning which makes the annual and/or quarterly meeting very valuable.

EP Liability Protection

Every person is responsible for their own acts, but there is every reason to try to limit liability for business operations. Yes, you can buy insurance to cover some hazards, but there are certain events that won't be covered by insurance, and there are dollar limits on the amount of coverage. For these reasons, most people seek an additional “insurance policy”—i.e., they select a form of doing business so that the business owner's personal responsibility

for business obligations and losses is limited. The forms that provide this protection are the corporation, the limited liability company and the limited liability partnership. A limited partnership can also provide protection to at least some of the owners. Operating as a sole proprietorship provides absolutely no protection from these liabilities.

The shield of any type of entity can be pierced if business owners do not follow the rules about how the business entity is to be governed and/or do not honor the distinction between the entity's pocket book and their own. That is another reason why this periodic review with advisors is so crucial. For example, if the business owners use the corporation, limited liability company or limited liability partnership to pay personal expenses without following some fairly specific rules, then creditors of the business can require the owners to pay the business's debts—even though the owners would otherwise not be responsible.

EP Tax Consequences Upon Sale

The form of business in which you operate has tremendous impact on the amount of tax you will pay upon the sale or transfer of the business. (For a complete discussion of these issues see the November, 1997 issue of **The Exit Planner**: “C or S Corporation: What Difference Does It Make?”.) The entity which enjoys the most favorable tax treatment during a business's operating years is not always the most favorable upon sale. As the prospect of sale or transfer looms larger, you and your advisors must adjust for this eventuality—an adjustment which must be made as far as ten years in advance.

IDENTIFYING PROBLEM AREAS

To assess the overall liability that you and your business incurs on an ongoing basis, you must periodically conduct a legal audit or perform what is often called “due diligence” or “issue spotting.” At a minimum, you and your team of advisors should:

- EP** Plan before the end of each year to limit your tax liability. Consider additional benefits for you and your employees. This can limit overall tax liability and help to keep your employees happy.
- EP** Limit your liability to your customers for the work you do. Have you read the warranties on your computer software lately? The software manufacturer states that its liability for a faulty product is limited to returning to you what you paid. It is not responsible for the money or time you spend learning to use a product that is faulty, or trying to recover or re-

input data lost if the system crashes. Consider similar provisions in your contracts to give you this level of protection. Examine your invoices and customer warranties carefully. Modify them, if necessary, to include protections appropriate to your industry.

- ▶ Avoid giving personal guarantees for business debts, or, at a minimum, limit your responsibility. For example, if you must guarantee your office lease, you might negotiate that your personal guarantee is limited to a certain period of time or amount of dollars.
- ▶ Read every contract you sign for the business carefully with an eye to limiting liability. For example, as a landlord you want the tenant to be responsible for everything and have no rights. As the tenant you want the exact opposite result. Another example is that a tenant wants the lease to be readily assignable, whereas the landlord generally wants the right to reject any new tenant. Often these issues can be negotiated.
- ▶ Negotiate any loan agreements to limit your personal or business liability or attempt to obtain a more favorable deal from your bank.
- ▶ Know and follow the state and federal employment laws regarding discrimination, employee compensation, and employee safety. Hiring and firing activities should be handled carefully to limit problems.
- ▶ Ask your attorney to examine your employee manual or hand-book to avoid adding to your burden as a business owner and limiting your flexibility in working with your employees.
- ▶ Consider separate entities to operate the business and to own business assets, such as land and large equipment. This can help to limit taxes, fund your children's education and limit liability.

While all of these “housekeeping” tasks will need to be performed upon the eventual sale of your business, it is good practice to keep your “house” in order now.

MOTIVATING AND RETAINING KEY EMPLOYEES

Every night the future of your business walks out the door. That future is your workforce, in particu-

lar your key employee(s). What can be done to ensure they return the next day, the next week, and the next year fully motivated to do their best? Consider offering them a piece of the rock—if not ownership, then a share of the profits.

Profit sharing should not be given away but should be earned, usually by means of an incentive bonus plan. The formula for the bonus can be designed to reward performance in specific areas, such as a share of the company's net profit above a base level. In addition to designing a benefit formula rewarding increased company performance, other elements of a well-designed key incentive bonus plan include:

- ▶ **A Vesting Schedule.** The vesting schedule encourages the employees to stay with you longer so that their ultimate pay-off percentage is larger.
- ▶ **Deferred Payment.** The benefit plan can defer payment of the bonus until after termination of employment, and then pay out over time.
- ▶ **Creating a Potential Buyer.** An additional attraction to keeping key employees is that they might be potential buyers of the business when you are ready to leave. You could have a plan to sell them stock over time with the bonus that has been deferred, or to sell them stock **now** subject to some type of vesting schedule.

Key employee benefit plans should be designed to account for the unique characteristics of your company, your objectives and your employees. Each such plan, however, should use a benefit formula that rewards your employee based on company performance—usually a share of the profitability. Secondly don't pay the entire benefit on a current basis—retain all or a portion and pay it to your key employees after they've retired (hopefully after you have!).

ENSURING CONTINUITY

Talking about business continuity in the event of your demise or disability is about as popular and as important as getting your teeth cleaned. Both need to be endured; both present larger problems from arising; both can be done largely by professionals. In some cases there are key employees who should become owners perhaps because they are the future

buyers, or because they simply are very important and stock ownership is key to them. In those cases, there are business planning opportunities which must take into account taxes to you and the employee, and your goals and theirs. Consider using vesting schedules or staged purchases of stock or restricted stock. The amount, if any, the employees will pay, must be determined, and a buy and sell agreement (discussed below) is necessary.

In a business with more than one owner, business continuity involves, in part, having a buy-sell agreement that covers how each owner's stock will be handled (who will buy it, and how much they will pay and when) on death or disability. The payments can be funded using insurance. In addition, sometimes even the most friendly group of business owners reach a point when they cannot agree anymore. The buy-sell agreement should provide for some way to get out of this co-ownership without a vicious and expensive court battle.

Equally important to business survival, and especially if you are the sole or majority owner, is having a strong management team in place. If you're not at the office—who is? And, can they run it? In these cases, business continuity is totally reliant upon your employees staying the course until the business can be sold. In addition to the incentive plans discussed above, one possibility is to offer key employees a “stay bonus” to entice them to see your company through its transition to a new owner. This bonus can also be funded with insurance on you, should you die or become disabled.

It is important to discuss these continuity issues in greater detail with your advisors, especially your insurance advisor.

ESTATE PLANNING

A business is often the most valuable asset a business owner has, and it can be worth more than anyone dreamed. This is a wonderful prospect for the families of those business owners who use proper planning to avoid, limit or delay the resulting estate tax.

However, estate planning for business owners is even less popular than business continuity planning. It is often like pulling teeth to get owners to sit down and plan their estates. Nevertheless, it is a most valuable part of overall, long-term business planning. Take the time to review your estate plan at your periodic meetings with your advisors. As a business owner, your estate plan is inextricably inter-

twined with your business issues relating to value, to business growth, to key employee motivation and retention, to family involvement and ownership of the business, and much more. All impact and drive your estate plan.

Good estate planning may include:

- Splitting assets (sometimes including the business) between husband and wife so that each owns at least as much as the “unified credit amount” (currently \$625,000)
- Gifts to children—either outright or in trust
- Use of family limited liability companies or partnerships
- Using life insurance—both personal and to pay off business debt—to allow the business to continue rather than possibly be shut down
- Planning for children who are interested in and capable of owning the business

One final thought on the need to carefully consider who should own any life insurance: People believe that insurance proceeds received will not be included in their taxable income. This may or may not be true. Tax treatment depends, among other things, on how the insurance is owned, how it was acquired, who pays the premiums, and who the beneficiary is who receives the proceeds.

WORKING WITH ADVISORS

As you can see, the variety of Business Planning issues is wide. No one advisor can do it all. Therefore, a team of advisors working together is necessary to adequately address all issues. That team includes your lawyer, your accountant, and your financial planner and/or insurance agent. Each person on that team has his or her own role and brings to the team a necessary expertise.

Without a good advisory team, business owners either waste valuable time and energy studying technical areas of Business Planning and/or coordinating and sifting through the various (and sometimes conflicting) advice that advisors can provide or, more likely, they do nothing at all.

How do you select this team? Each of these advisors must be knowledgeable in his or her own area and be pro-active, not just re-active. The goal is to plan, not resolve problems that present themselves due to inadequate planning. Further, each person must be willing to share information and responsi-

bility and be committed to this group effort. The goal is to provide the best planning for the business owner, not to inflate the ego of the advisor.

Most importantly, each advisor must be able to see the big picture—all business planning is done at least to preserve and at best to increase business value. You can't afford advisors who lose the forest for the trees. Look to your existing advisors to suggest other professionals who can assist you in this planning process.



Barbara J. Wells is the Director of Business Planning at the law firm of Minor & Brown, P. C. in Denver, Colorado. For over twenty years, the firm has helped owners of privately held companies preserve and increase the value of their companies. Ms. Wells can be reached at (303) 320-1053.

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PRODUCTION STAFF

Editor Kathryn B. Carroll
Design and Production Georgianne Bender
Andrew H. Leman

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Subscriptions to *The Exit Planner* are available for \$49.00 per year by contacting:

Theresa Carlsen
Business Enterprise Institute, Inc.
650 S. Cherry Street, Suite 1100
Denver, Colorado 80246
(303) 321-2242
TOLL FREE: (888) 206-3009
FAX: (303) 320-6330

We at The Exit Planner, are happy to answer any questions you have about articles that appear here. We also appreciate suggestions from readers about the Exit Planning topics that they wish to see addressed. We welcome your comments regarding our newsletter. You can address your questions, comments or suggestions to: John H. Brown, President, Business Enterprise Institute, 650 S. Cherry Street, Suite 1100, Denver, Colorado 80222 (303) 321-2242.

THE EXIT PLANNER past issues available for purchase. \$5.00 per copy.

MARCH, 1997 Saving Millions While Giving it Away

This issue of *The Exit Planner* addresses the part of the Exit Planning process designed to help you hang on to as much of the proceeds from the sale of your business as possible. Specifically, we look at the design, pros and cons of a Charitable Remainder Trust (CRT).

MAY, 1997 Girding Your Loins and More/*The Top Three Questions Business Owners Ask Before Selling Their Businesses*

This issue answers the three questions most frequently asked by business owners who are contemplating selling their businesses.

JULY, 1997 Beauty Is In The Eye Of The Beholder/*The Eye of the Beholder*

To understand the value of a business and its cash flow from the buyer's perspective, several factors need to be examined that are generally not considered by CPAs and other business appraisers when they value a business.

NOVEMBER, 1997 Where the Rubber Meets the Road/*C or S Corporation: What Difference Does it Make?*

The best form of business entity (C or S) for tax purposes during a business's start up and operational years may not be the best when it comes time to sell the business. Find out why and what you can do about it.

FEBRUARY, 1998 Inevitabilities/*Exit Planning*

At some point, every owner leaves his or her business—voluntarily or otherwise. This issue discusses a proven seven-step Exit Planning process designed to maximize the business owner's financial and other goals.

APRIL, 1998 Growing Your Business Through Acquisition

Done correctly, acquiring a business helps a business owner to build value in his own. This issue discusses how to be a "prepared buyer."

JULY, 1998 Godzilla the Consolidator/*What to do When the Consolidator Calls*

Read this vital issue to learn "the rules" that put you—not the consolidator—in control of the sales process.